Attachment 3

Minutes of January 2011 ECC Meeting

DEPARTMENT OF CONSUMER AFFAIRS
CALIFORNIA BOARD OF ACCOUNTANCY
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DEPARTMENT OF CONSUMER AFFAIRS (DCA)
CALIFORNIA BOARD OF ACCOUNTANCY (CBA)

ECC Agenda Item I
April 6, 2011

MINUTES OF THE January 26, 2011 ETHICS CURRICULUM COMMITTEE (ECC) MEETING

Crowne Plaza Irvine
17941 Von Karman Avenue
Irvine, CA 92614
Telephone: (949) 863-1999

I. Roll Call and Call to Order

Donald Driftmier, Chair, called the meeting of the ECC to order at 1:01p.m. on Wednesday, January 26, 2011 at the Crown Plaza Irvine. Mr. Driftmier indicated that to ensure compliance with the Bagley-Keene Open Meeting Act, Section 11122.5(c)(6), if a majority of members of the full CBA are present at a committee meeting, members who are not members of that committee may attend the meeting only as observers. CBA members who are not committee members may not sit at the table with the committee, and they may not participate in the meeting by making statements or by asking questions of any committee members.

ECC Members	
Donald Driftmier, Chair	1:01 p.m. to 4:26 p.m.
Dave Cornejo	1:01 p.m. to 4:26 p.m.
Gonzalo Freixes	1:01 p.m. to 4:26 p.m.
Gary McBride	1:01 p.m. to 4:26 p.m.
Jon Mikkelsen	1:01 p.m. to 4:26 p.m.
Steven M. Mintz	1:01 p.m. to 4:26 p.m.
Gary Pieroni	1:01 p.m. to 4:26 p.m.
Robert Yetman	1:01 p.m. to 4:26 p.m.
Michael Ueltzen	Not Present
Michael Shames	Not Present

<u>CBA Members</u>
Sally Anderson, President

<u>Staff and Legal Counsel</u>
Patti Bowers, Executive Officer
Deanne Pearce, Chief, Licensing Division
Dominic Franzella, Manager, Licensing Division
Cindi Fuller, Licensing Coordinator

Rich Andres, Information Technology Staff
Matthew Stanley, Legislation/Regulation Analyst

<u>Other Participants</u>
Hal Schultz, California Society of Certified Public Accountants (CalCPA)
Jeannie Tindel, CalCPA
Pilar Onate-Quintana, KP Public Affairs
Joe Petito, The Accountants Coalition, PWC
Ellen Glazerman, Ernst & Young
Chrislynn Freed, California Society of CPAs, Accounting Education Committee
Randolph P. Beatty, Dean, Leventhal School of Accounting, University of Southern California
Christopher G. Jones, California State University, Northridge
Sharon Lightner, San Diego State University
Bill Holder, Ernst & Young, Professor at USC
Susan Parker, Leavey School of Business, Santa Clara University

II. Approve Minutes of the September 21, 2010 ECC Meeting

It was moved by Mr. Pieroni, seconded by Mr. Gonzalo, and unanimously carried by those present to approve the minutes (**Attachment #1**).

III. Applicants for California CPA Licensure with Education Completed Out of State

Mr. Franzella presented the memorandum (**Attachment #2**) for this item.

Mr. Franzella reported on the six-week study used to evaluate applicants for CPA licensure that completed education outside California. He also reported that the Accounting Education Committee (AEC) had expressed interest in this area and that the study validated the need to disseminate the recommendations of both the committees nationally. Staff suggested the CBA could circulate the recommendations through the interested parties list, which includes California colleges and universities, as well as sending a mailing to various colleges and universities throughout the United States in addition to using the National Association of State Boards of Accountancy (NASBA), the American Institute of Certified Public Accountants (AICPA) and other resources that may be available.

IV. Ethics Requirements for CPA Licensure of Other State Board of Accountancy

Ms. Fuller presented the memorandum (**Attachment #3**) for this item.

Ms. Fuller reported on the information provided by the Texas State Board of Public Accountancy regarding the development and implementation of their ethics requirement, as well as, additional information on the educational requirements of other state boards of accountancy.

V. Research Materials Provided by ECC Members and Information on Ethics Study

Ms. Fuller presented the memorandum (**Attachment #4**) for this item.

Ms. Fuller reported that at the last meeting, to assist members in establishing the framework on ethics study, the Chair had requested members research their college/university to see where ethics was embedded in courses. Members presented their findings to the committee and provided clarification to questions posed regarding their research. Mr. Driftmier presented the research information submitted by Mr. Ueltzen and Mr. Shames.

Discussions focused on the availability of stand-alone and embedded ethics courses offered by the accounting and business departments, as well as, in other departments. Members also discussed the availability of courses to accounting majors in other departments, and requiring an accounting ethics course as part of the 10 units.

Mr. Driftmier informed the committee that within the past few days he had received several letters regarding the composition of the 10 units of ethics study. The Chair requested the minutes reflect the letters received from University of Southern California, California State University, Northridge, University of California, Riverside, University of California, Santa Barbara, Azusa Pacific University, California State University, Fresno, University of San Diego, San Jose State University, Undergraduate Programs at Anderson (University of California, Los Angeles), California State University, Monterey Bay, and CalCPA Accounting Education Committee. He requested these letters be added to the next agenda to further address and review their concerns and suggestions.

Mr. Jones stated CSU, Northridge had a Master's of Taxation program. These graduates receive ethics instruction in professional responsibility in tax which is embedded in the graduate course work. He further stated that most ethics courses are in the Philosophy and Religious Study departments which may not be available to accounting students.

VI. Ethics Study Required by Business and Professions Code Section 5093

Mr. Franzella presented the memorandum (**Attachment #5**) for this item.

Mr. Franzella provided an overview of additional background information submitted by CalCPA and CPIL on Senate Bill 819, the impact of recommending less than 10 units of ethics study, and the next steps in recommending ethics guidelines to the CBA.

Members discussed the flexibility in allowing courses outside the accounting department but still requiring a dedicated course in accounting ethics.

Mr. Stanley clarified the timeframe and process for legislation. He stated legislation would not be needed unless the committee recommended less than 10 units. He informed the committee that double dipping (counting a course towards two requirements) was not in the law but was heavily implied. Mr. Driftmier requested Mr. Stanley provide at the next meeting a timeline should any legislative language be required.

Mr. Yetman suggested the committee first attempt to find 10 units of ethics study before considering reducing the total amount of units. He suggested the 10 units be comprised of three units of a stand-alone accounting ethics course and the remaining seven units could be comprised of business law, corporate law, and corporate governance courses and credit for ethics could be given for each accounting course. He suggested that ethics courses such as a solid philosophy course in ethics should be considered. These 10 units could be identified by the course title without relying on the course description.

Mr. Beatty supported the notion of three units of a stand-alone course. He stated undergraduate general education courses included ethics; therefore, students receiving a degree from an accredited institution should automatically be credited or “spotted” units towards the ethics study requirement. He had concerns regarding the implementation timing of this requirement and how it would impact current freshman and graduate students. He also echoed concerns regarding budget constraints imposed on institutions.

Ms. Lightner was in favor of the concept of “spotting” credit for general education courses. She encouraged members to consider budget issues faced by institutions. She informed members that students are asked to leave after completing 120 units and this could impose an added burden to students.

Ms. Parker relayed the urgency for the committee to craft the requirements as these 10 units would most likely affect juniors now. She stated a broad description of ethics would allow more courses.

Ms. Freed expressed her thanks for the committee’s work and urged the committee to consider the economically challenged student.

Ms. Anderson, CBA President, thanked the committee for all their work. Ms. Anderson asked those members associated with colleges and universities how difficult it would be for their institutions to identify ethics on a course-by-course basis as it pertained to transcripts.

Mr. Jones wanted to clarify that when speaking of embedded courses there are typically 15 contact hours for each unit.

After further discussion, a subcommittee, consisting of Mr. McBride and Mr. Yetman, was established to draft framework for the ethics study guidelines. The subcommittee was to meet with staff and present their proposal at the next meeting.

VII. Future Meeting Dates

It was moved by Mr. Cornejo, seconded by Mr. Pieroni, and unanimously carried by those present to approve the meeting dates set forth in the presented memorandum. (**Attachment #6**)

ADJOURNMENT.

There being no further business to be conducted, the meeting was adjourned at 4:26 p.m. on Wednesday, January 26, 2011.

/Donald A. Driftmier/
Donald A. Driftmier, Chair

Prepared by Cindi Fuller, Licensing Coordinator

STATE OF CALIFORNIA - STATE AND CONSUMER SERVICES AGENCY GOVERNOR EDMUND G. BROWN JR.

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DEPARTMENT OF CONSUMER AFFAIRS
CALIFORNIA BOARD OF ACCOUNTANCY

<u>CBA Agenda Item XIII.D.</u>
January 27-28, 2011

<u>ECC Agenda Item II</u>
January 26, 2011

Draft

MINUTES OF THE
September 21, 2010
ETHICS CURRICULUM COMMITTEE (ECC) MEETING

California Board of Accountancy
2000 Evergreen Street, Suite 250
Sacramento, CA 958151
Telephone: (916) 263-3680

ROLL CALL AND CALL TO ORDER.

Donald Driftmier, Chair, called the meeting of the ECC to order at 10:03 a.m. on Tuesday, September 21, 2010, at the California Board of Accountancy. Mr. Driftmier indicated that to ensure compliance with the Bagley-Keene Open Meeting Act, Section 11122.5(c)(6), if a majority of members of the full California Board of Accountancy (CBA) are present at a committee meeting, members who are not members of that committee may attend the meeting only as observers. CBA members who are not committee members may not sit at the table with the committee, and they may not participate in the meeting by making statements or by asking questions of any committee members.

<u>ECC Members</u>

Donald Driftmier, Chair	10:03 a.m. to 3:04 p.m.
Dave Cornejo	10:03 a.m. to 3:04 p.m.
Gonzalo Freixes	10:03 a.m. to 3:04 p.m.
Gary McBride	10:03 a.m. to 3:04 p.m.
Jon Mikkelsen	10:03 a.m. to 3:04 p.m.
Steven M. Mintz	10:03 a.m. to 3:04 p.m.
Gary Pieroni	10:13 a.m. to 3:04 p.m.
Michael Shames	11:03 a.m. to 3:04 p.m.
Michael Ueltzen	10:03 a.m. to 3:04 p.m.
Robert Yetman	10:03 a.m. to 3:04 p.m.

<u>Staff and Legal Counsel</u>
Patti Bowers, Executive Officer
Dan Rich, Assistant Executive Officer
Dominic Franzella, Manager, Licensing
Cindi Fuller, Licensing Coordinator
Rich Andres, Information Technology Staff
Matthew Stanley, Legislation/Regulation Analyst
Gary Duke, Legal Counsel, DCA

Spencer Walker, Legal Counsel, DCA

Other Participants
Hal Schultz, California Society of Certified Public Accountants (CalCPA)
Jeannie Tindel, CalCPA
Pilar Onate-Quintana, KP Public Affairs
Molly Isbel, KP Public Affairs
Joe Petito, The Accountants Coalition, PWC
Ellen Glazerman, Ernst & Young
Ramona Farrell, Ueltzen & Co.

I. Welcome and Introductions

ECC Chair Donald Driftmier called the meeting to order on September 21, 2010, and asked ECC Members and CBA staff to introduce themselves. Gary Duke, DCA Senior Staff Legal Counsel, introduced Spencer Walker, newly appointed Legal Counsel for the CBA. Mr. Driftmier provided a brief overview on the establishment of the ECC.

II. Introduction to the Bagley-Keene Open Meeting Act

Spencer Walker presented the memorandum (**Attachment 1**) for this item. Mr. Walker recommended that each member attend the Department of Consumer Affairs' board member training. Mr. Walker advised the ECC members that all state bodies are subject to the Bagley-Keene Open Meeting Act, including advisory committees established by the CBA. Mr. Walker explained that the purpose of the Bagley-Keene Open Meeting Act is to facilitate accountability and transparency of governmental activities and protect the rights of citizens to participate in State government deliberations. Mr. Walker provided ECC members powerpoint copies of the Bagley-Keene Open Meeting Act (**Attachment 2**) and copies of *"A Handy Guide to the Bagley-Keene Open Meeting Act 2004"* **(Attachment 3)** prepared by the California Attorney General's Office. Mr. Walker reviewed the top ten rules of the Bagley-Keene Open Meeting Act, as identified by the Department of Consumer Affairs Division of Legal Affairs, and also answered questions regarding the meaning of a serial meeting and the ability to use subcommittees.

III. Economic Travel – Official State Business

Mr. Rich presented the memorandum (**Attachment 4**) for this item on behalf of Deanne Pearce, Chief, Licensing Division. Mr. Rich advised ECC members of the requirement to complete a travel expense claim in order to receive reimbursement for travel expenses and reinforced the importance of using the most economic means of travel to meetings and also to hold meetings at low-cost or no-cost locations. Mr. Rich explained that for future ECC meetings members will receive a travel memorandum specifying the meeting location, driving directions, information related to airline reservations, and CBA staff contact information.

Member Michael Shames arrived during the presentation of this agenda item and was introduced by Mr. Driftmier.

IV. Overview of the CBA and Common Services Provided by CPAs

Mr. Franzella presented the memorandum (**Attachment 5**) for this item. Mr. Franzella advised ECC members the role of the CBA and the common services provided by Certified Public Accountants (CPAs). This information was provided for contextual purposes as members begin their discussion on the ethics study guidelines.

Mr. Dirftmier noted that a number of CBA members sit on various committees through the American Institute of Certified Public Accountants (AICPA) and National Association of State Boards of Accountancy (NASBA).

V. Overview of Licensure Requirements and the Effects of Senate Bill 819 on the Pathways to Licensure

Mr. Franzella presented the memorandum (**Attachment 6**) for this item.

Mr. Franzella clarified for committee members that Senate Bill (SB) 819 requires the CBA to adopt the ECC's recommendation for ethics study guidelines without making any substantive changes. Mr. Yetman inquired what method is presently used to determine whether a course meets the 24/24 requirement. Mr. Franzella stated that the CBA generally relies on the transcripts.

VI. ECC Directives and Goals

Mr. Franzella presented the memorandum (**Attachment 7**) for this item.

Mr. Mintz questioned whether the directive to determine the appropriateness and feasibility implied that the final recommendation could be less than 10 units or no ethics education. Ms. Tindel stated that as one of the individuals who helped craft the compromise the committee is trying to implement, it was fully understood that it might not be feasible for 10 units to be accomplished. She further stated that the anticipation was if the recommendation was for less than 10 units of ethics education then a statutory change would need to be pursued.

Members questioned the authority in addressing the appropriateness as it is not specifically addressed in the legislative language. Mr. Franzella stated that the appropriateness portion came specifically from the CBA. He stated that at the November 2009 CBA meeting discussions were held that if the ECC came to the conclusion that 10 units were not feasible, the CBA could then go back to the Legislature to pursue a legislative change. Mr. Ueltzen stated he had limited fingerprints on SB 819 and the intent of stakeholders was to have academia, specifically the ECC and not the profession, study the issue, and if 10 units were not feasible then it was understood legislation would need to be pursued.

Mr. Freixes suggested should members decide to recommend less than 10 units they should also come up with 10 units of curriculum as an option. Mr. Stanley stated that the basic intent of the CBA was to have the ECC present their recommendation of what they think best and then have the CBA go back and try to get the law changed if needed.

Mr. Driftmier requested staff provide information on the impact should the ECC recommend less than 10 units of ethics study.

VII. Discussion Regarding Composition of the 10 Units of Ethics Study Required by Business and Professions Code Section 5093

Ms. Fuller presented the memorandum (**Attachment 8**) for this item.

Mr. Driftmier provided members a copy of an article pertaining to the role schools play in promoting corporate social responsibility (**Attachment 9**), as well as, a sampling of courses taught at the University of California, Berkeley that could possibly pertain to the topic of ethics. Mr. Yetman explained that simply because a course was listed in a course catalog did not mean the course was actually being offered, so if 10 units were found, to assume all of the hours would be attainable to the student over a period of two or three years could be a mistake.

Members provided preliminary input on their particular institution as to the feasibility of teaching a course, students taking a course, and where it would fall in curriculum guidelines. In addition, extensive discussion was held regarding stand alone ethics courses and courses where ethics was embedded.

Ms. Glazerman clarified the terms AQ - academically qualified - and PQ - professionally qualified - and the relevance of the person teaching a course. She further clarified that accreditation has everything to do with the business school but if extension courses are offered outside of the business school they are not necessarily part of the accreditation scope.

Mr. Shames stated that the University of San Diego had two courses specifically dedicated to ethics. Mr. Driftmier expressed that this information would be beneficial to members and requested Mr. Shames provide copies of the course materials.

Mr. Driftmier requested members research their colleges/universities to find where ethics was embedded in courses, the level the course was currently being taught, in what department and who taught the course. Ms. Tindel requested that as part of their research the definition of ethics also be included. Mr. Driftmier agreed and requested the definition of ethics be included in the research.

Members requested staff provide additional information regarding the ethics requirements for other state boards of accountancy. Mr. Ueltzen requested information on the development and implementation of the ethics requirements for the state of Texas.

Mr. Petito raised concerns about California students taking courses outside of California and how those courses, especially courses where ethics was embedded, would meet California standards. He also suggested that there could be some generic number that one could assume a student going through an accredited school in an accounting program would have gotten for embedded ethics courses.

Mr. Mikkelsen requested Mr. Ueltzen provide insight from the industry standpoint and give his perspective regarding when ethics education should take place, what should be taught in relation to ethics, and what might maximize the effectiveness of the ethics education for those individuals actually in practice.

VIII. Comments from Members of the Public.

To assist in calendaring future meetings, Mr. Franzella inquired if there was a particular day of the week that was not good for members. There was a general consensus that future meetings be held on a specific day of the week to assist members in setting their school calendars. Ms. Bowers stated a survey would be sent to members as to their preference.

ADJOURNMENT.

There being no further business to be conducted, the meeting was adjourned at 3:04 p.m. on Tuesday, September 21, 2010.

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Donald A. Driftmier, Chair

Prepared by Cindi Fuller, Licensing Coordinator

State of California
Department of Consumer Affairs

Attachment 2

California Board of Accountancy
2000 Evergreen Street, Suite 250
Sacramento, CA 95815-3832

M e m o r a n d u m

ECC Agenda Item III.
January 26, 2011

To : ECC Members

Date : December 20, 2010

Telephone : (916) 561-4310
Facsimile : (916) 263-3676
E-mail : dfranzella@cba.ca.gov

From : Dominic Franzella, Manager
License Renewal & Continuing Competency Unit

Subject : Applicants for California CPA Licensure with Education Completed Out of State

At the September 21, 2010 Ethics Curriculum Committee meeting, members requested information regarding the number of applicants applying for California Certified Public Accountant (CPA) licensure with education completed out of state. At that time staff informed members that the California Board of Accountancy (CBA) did not track such information. In an effort to be responsive to members' request, staff embarked on a six-week study to track the educational qualifications of applicants approved for CPA licensure – specifically, to track where licensees completed their college/university education.

The study began November 1, 2010 and concluded December 15, 2010. During that time staff approved 657 applicants for CPA licensure. Below are the results of the study.

Where Education Was Completed	Total	%[1]
California Only	381	58%
Out of State Only	128	19%
California and Out of State	60	9%
Foreign Only	41	6%
California and Foreign	27	4%
Out of State and Foreign	15	2%
California/Out of State/Foreign	5	1%

[1] Total percentage is less than 100%.

General Observations

- 72% of approved applicants completed all or some of their education in California.

- 41% of approved applicants completed all or some of their education outside of California.

- 28% of approved applicants completed all of their education outside of California.

Though staff conducted only a limited study on this topic, it provides the CBA, ECC, and Accounting Education Committee (AEC) (which has also expressed interest in this topic) with valuable information regarding the significant number of applicants obtaining some or all of their education out of state. Consequently, this study further underpins what the CBA already understood – the need to communicate nationally those changes impacting the CPA profession in California.

Based on a suggestion raised at previous AEC meetings, as the AEC and ECC come closer to offering final recommendations on their respective units, staff will mail the recommendations (mostly likely in regulation form) to the CBA's interested parties list, which includes California colleges and universities. Also, in light of the outcome of this study, staff believe it is prudent to circulate the proposed recommendations on a national scale by mailing to various colleges and universities throughout the United States, as well as to the National Association of State Boards of Accountancy and American Institute of Certified Public Accountants. Staff would greatly appreciate additional suggestions ECC members might have on possible methods for outreach regarding the upcoming licensure changes.

State of California
Department of Consumer Affairs

Attachment 3

California Board of Accountancy
2000 Evergreen Street, Suite 250
Sacramento, CA 95815-3832

Memorandum

ECC Agenda Item IV.
January 26, 2011

To : ECC Members

Date : December 15, 2010

Telephone : (916) 561-4367
Facsimile : (916) 263-3672
E-mail : cfuller@cba.ca.gov

From : Cindi Fuller, Coordinator
Licensing Division

Subject : Ethics Requirements for CPA Licensure of Other State Boards of Accountancy

At the September 21, 2010 Ethics Curriculum Committee (ECC) meeting, members requested additional information regarding the development and implementation of the ethics requirements for Certified Public Accountant (CPA) licensure established by other state boards of accountancy.

Members specifically requested the Texas State Board of Public Accountancy be contacted to inquire of its own experience in implementing its three unit board-approved ethics requirement. In response to members' request, staff contacted the Texas State Board of Public Accountancy and posed the below questions to the Executive Director.

- When did the ethics education requirement for CPA licensure take effect?
- What, if any, was the rationale for implementing such a requirement?
- How did the Texas State Board of Public Accountancy settle on requiring three units?
- Who performs the review and makes the recommendations on the approvals?
- We understand that ethics courses must be pre-approved through the Texas State Board of Public Accountancy. How does a college/university apply and get approved, and how does it maintain its approval?

Provided in **Attachment 1** is the response received from Texas.

In addition to Texas, staff reviewed the educational requirements of other state boards of accountancy via their Web sites and identified the following states as having some level of ethics education built into their requirements – Alabama, Arizona, Hawaii, Maine, Maryland, Michigan, Nebraska, Nevada, New York, Ohio, and West Virginia. Staff found that Maryland, New York, West Virginia, and Texas actually require the completion of ethics study.

Provided below is additional information regarding the research done on other state boards of accountancy's ethics educational requirements (excluding Texas).

Maryland

Maryland requires the completion of three undergraduate units of ethics education in business ethics, accounting ethics, or philosophy of ethics. Maryland requires that the three units be devoted to the study of ethics. Introductory Philosophy or Theology courses are not acceptable as they substantially are not devoted to the study of ethics; however, upper-level Moral Theology or Moral Philosophy courses where the focus is ethics are acceptable.

Maryland will not accept courses that combine the study of ethics with other substantive disciplines or studies (e.g., a course titled "Legal and Ethical Environment of Business" will not be acceptable). Courses with an ethics component will not fulfill the three-unit requirement. From time to time, applicants will argue that ethics was taught across the curriculum. As there is no reasonable way to verify this claim, Maryland does not allow credit unless a course has a published number of credits designated as "ethics" credits.

New York

New York requires courses be taken in ethics and professional responsibility but does not specify the amount of units. Typical course titles that would fall under the content area of ethics and professional responsibilities include auditing, business law, commercial law, and business ethics. Ethics courses may be taken from the Liberal Arts Department and course content may be integrated into other courses or serve as stand-alone courses.

West Virginia

Beginning July 1, 2011, West Virginia will require the completion of three units in ethics study. These units may be counted as part of the required accounting or business-related electives which amount to nine units respectively for each area of concentration.

The remaining nine states simply accept ethics courses to fulfill the accounting or business-related education requirements. Staff was unable to locate any information that provides any specifics regarding the type of ethics courses.

Attachment

Texas State Board of Public Accountancy

333 Guadalupe, Tower III Suite 900, Austin, Texas 78701-3900

William Treacy, Executive Director

November 3, 2010

Attachment 1

Patti Bowers
Executive Officer
California Board of Accountancy

Ms. Bowers:

I received your email concerning changes to the California CPA licensure and the implementation of 10 units of ethics study. Donna Hiller, Director of Qualifications, and I would be available to participate in a conference call to answer questions about the Texas State Board of Public Accountancy's experience in implementing our ethics requirement. The following information is provided as you begin to develop the framework for the course of study in ethics.

<u>When did the ethics education requirement for CPA licensure take effect?</u>

Texas amended *Board Rule 511.58 – Definitions of Related Business Subjects* to include the requirement for a 3-semester-hour college course in ethics in February, 2003. Qualified courses had to be approved by the Board, taken at a recognized educational institution, and contain core values such as ethical reasoning, integrity, objectivity and independence. The Qualifications Committee (QC) of the Board reviewed each course syllabus and class schedule to determine that the course met the requirements of the rule. A variety of ethics courses, offered in various university departments from philosophy to business, were accepted. As the QC worked through this process, it narrowed the focus and began approving only ethics courses offered in some departments of business. The QC developed an ethics matrix that was helpful in its review process and also began to require inclusion of accounting and business moral dilemmas and case studies, as well as incorporation of the AICPA, SEC, and Texas Board ethics rules.

In January, 2009, the rule was amended with respect to the ethics requirement.

(c) In addition to the 24 hours required in subsection (b) of this section, the board requires that 3 passing semester hours be earned as a result of taking a course in ethics. The course must be taken at a recognized educational institution and should provide students with a framework of ethical reasoning, professional values and attitudes for exercising professional skepticism and other behavior that is in the best interest of the public and profession. The ethics program should provide a foundation for ethical reasoning and include the core values of integrity, objectivity and independence taught by an instructor who has not been disciplined by the board for a violation of the board's rules of professional conduct unless waived by the board.

The 2009 amendments were implemented to track the ethics requirement in NASBA's model rules 5-1 and 5-2.

What, if any, was the rationale for implementing such a requirement?

In 2001, as a result of the collapse of Enron, the Texas legislature expressed concern that CPAs and those desiring to hold the CPA designation exhibit high ethical standards as well as comply with the Board's Rules of Professional Conduct. As information became available about the involvement of CPAs in the Enron matter, it became evident to the Board that formal education in business ethics was needed. The QC, which is comprised of accounting educators and CPAs, was aware that ethics information was integrated in a number of accounting courses; however, a discrete course covering accounting ethics was not offered. There was push back by some educators who believed that ethics could not be taught. Over the 7 years that a discrete ethics course has been required in Texas, there has been a change of opinion. Bill Thomas, PhD, CPA, Baylor University, completed a study for the Board about accounting ethics education in 2005. He is now working on a follow-up to the survey to determine if the ethics course requirement has been beneficial to CPAs who were certified within the past five years. The number of enforcement complaints related to ethical violations requiring Board action has significantly decreased since the implementation of the rule and we believe it is reasonable to assume that there is a correlation between the rule and the decrease in complaints.

How did the Texas State Board of Public Accountancy settle on requiring three units?

Foundation building courses offered by higher education institutions have historically been 3-semester-hour courses; e.g. philosophy or humanities courses. With business ethics curriculum already integrated into the accounting degree plan, the Board believed the material the student needed could be completed in one 3-semester-hour class.

Who performs the review and makes the recommendations on the approvals?

Initial reviews are made by the agency's Qualifications Division Director, Donna Hiller, prior to the QC review. For a course to be considered, the university submits the syllabus, class schedule, and ethics matrix. If questions arise during the initial review, or the material is incomplete, Ms. Hiller contacts the course instructor for additional information. When the QC considers the ethics course, it may: (1) approve the course as presented, (2) approve the course with stipulations, (3) require additional information or clarification prior to approval, or (4) deny approval for the course.

Texas State Board of Public Accountancy
333 Guadalupe, Tower III Suite 900, Austin, Texas 78701-3900
William Treacy, Executive Director

We understand that ethics courses must be pre-approved through the Texas State Board of Public Accountancy, how does a college/university apply and get approved, and how does it maintain its approval?

The requirements for consideration of an ethics course by the Board are provided on its website. The link is provided for your use. http://www.tsbpa.state.tx.us/education/ethic-course-requirements.html Schools are contacted at three-year intervals and asked to provide information about the approved ethics course so that it may be reconsidered for reapproval. When an ethics course is approved, the school is informed and also is asked to notify the Board if there is a significant change to the syllabus or instructor(s), or if the class is no longer offered.

We are of course available to provide additional information about our efforts if you have additional questions.

Yours very truly,
Texas State Board of Public Accountancy

William Treacy
Executive Director

Administration/ Accounting	Automated Information	CPE	Enforcement	Licensing	Qualifications	Peer Review	FAX
(512) 305-7800	(512) 305-7870	(512) 305-7844	(512) 305-7866	(512) 305-7853	(512) 305-7850 (512) 305-7851	(512) 305-7853	(512) 305-7875 (512) 305-7854

www.tsbpa.state.tx.us

State of California
Department of Consumer Affairs

Attachment 4

California Board of Accountancy
2000 Evergreen Street, Suite 250
Sacramento, CA 95815-3832

M e m o r a n d u m

ECC Agenda Item V.
January 26, 2011

To : ECC Members

Date : December 15, 2010

Telephone : (916) 561-4367
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From : Cindi Fuller, Coordinator
Licensing Division

Subject : Research Materials Provided by ECC Members and Information on Ethics Survey

At the September 21, 2010 Ethics Curriculum Committee (ECC), extensive discussion was held regarding the topic of ethics being embedded in existing college/university courses. As a result of this discussion and to assist members in establishing the framework on ethics study, ECC Chair Donald Driftmier, CPA, requested members research their college/university to see where ethics was embedded in courses. The Chair requested the research materials include where and at what level the course was currently being taught, in what department, who taught the course, and members' institutions' definition of ethics.

In addition to the above-referenced research, members also requested that Mr. Michael Shames and Mr. Michael Ueltzen, CPA, provide certain information. Mr. Shames was requested to provide copies of course offerings for two ethics-related classes he has previously instructed at the University of San Diego. Mr. Ueltzen, being a member of industry, was requested to provide members insight from the industry perspective as to when ethics education should occur, what should be taught, and what might maximize its effectiveness for people actually in practice.

Attached are the materials staff received in connection with the requested research.

In a preliminary review of the research materials submitted on ethics provided by the college/university professors on the committee and the materials provided by Mr. Shames, staff observed the following:

- It appears that of the schools surveyed there are several courses dealing with ethics either in a stand-alone format or with the topic embedded in a broader course.

- It appears that for selecting stand-alone courses where ethics is the primary focus and the term appears in the course title, a student would be required to take a course in a department other than business.

- For some upper division course offerings, it appears students may need to meet certain prerequisites in order to enroll in the course.

- It appears that several institutions offer courses in Human Resource Management and Corporate Governance where the topic of ethics is embedded.

Most members will be available at the January 2011 meeting to provide further information and insight regarding the materials provided.

Attachment

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ATTACHMENT

RESEARCH MATERIALS PROVIDED BY ECC MEMBERS

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MONTEREY PENINSULA COLLEGE

Dominic Franzella

Subject: FW: ECC ethics research: Community college ethics learning opportunities
Attachments: Community College Ethics Classes.docx; MPC ethics embedded business courses.docx

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From: [redacted]
Sent: Monday, November 22, 2010 3:22 PM
To: Cindi Fuller
Subject: RE: ECC ethics research: Community college ethics learning opportunities

Hi Cindi:

After reviewing the assignments in a bit more detail, I added some more work to make sure my contribution is complete.

The last submission, included again as "Community College Ethics Classes.docx", reviews a sampling of ethics specific courses available in the California Community College systems.

A new addition, attached as "MPC ethics embedded business courses.docx", involved interviewing our instructors to find where ethics instruction is included as part of our non-ethics-titled business classes. I believe this was specifically requested in the assignment. There is a fair amount of ethics hidden here, and these courses are all designed as a part of the first two years of post-secondary studies.

Another smaller portion of the assignment was to offer our definition of ethics, so here you go:

General ethics:
Ethics is our concept of right and wrong. The sources of those beliefs include spiritual and culture experiences which lead to semi-permanent ethical norms which at times appear to be common enough to represent a subset of people, a culture, or uncommonly everyone (seemingly). Ethics is also behavioral, in terms of our propensity to follow ethical beliefs or even to develop and apply a system of ethical decision making to enable us to make ethically sound decisions. Ethics is also highly situational, adapting to our abilities, and our needs and threats as our surroundings and standing change – think of one person moving through life, or an entire culture moving through history.

Or, in accounting:
Minimize the opportunity for fraud and inefficiencies with respect to all stakeholders. Ensure the numbers reflect the reality of the business so that decisions are based on sound information and money flows to its most appropriate use.

Please distribute as you see fit, including forwarding the message if you feel that is appropriate.

I will consider this complete unless you ask for more.

Thank you,
Jon Mikkelsen

From: Cindi Fuller [[redacted]]
Sent: Monday, October 18, 2010 3:53 PM
To: Jon Mikkelsen
Subject: RE: ECC ethics research: Community college ethics learning opportunities

Dear Mr. Mikkelsen:

I'm sorry to have responded so late. I just wanted to confirm receipt and will let Dominic know that you have completed your research.

If you have any questions, please let me know.

Thank you,

Cindi Fuller, Coordinator
Renewal/Continuing Competency Unit
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FAX: (916) 263-3672

From: Jon Mikkelsen [[redacted]]
Sent: Wednesday, October 13, 2010 3:51 PM
To: Cindi Fuller
Subject: ECC ethics research: Community college ethics learning opportunities

Hi Cindi,

Hopefully this document is supposed to go to you. I've finished the research that I offered to do. It involved sorting through accounting and other programs in the California community college system to uncover what is already being taught in ethics and related courses. I believe that Donald wanted to make these little assignments of ours available to all members of ECC committee. Are you are able to share it for me?

Thank you,

Jon Mikkelsen

Monterey Peninsula College

831-646-4072

Monterey Peninsula College's business courses with significant emphasis on ethics.

This document includes the course titles and descriptions along with brief coverage of how each course addresses ethics.

Business 1A Financial Accounting – university transferable first accounting course

Ethics standards, the AICPA code of ethics, and light ethical decision making process coverage is part of the course introduction and first chapter of study. A later chapter covering financial assets and internal controls is richer than average in ethical coverage. Fraud, internal controls, ethical decision making, and the accountants' role in ensuring ethical business operations are all used as learning tools throughout the course.

Business 1B Managerial Accounting – university transferable second accounting course

An ethical decision making process is introduced in the context of decision making within a company. Ethics cases and applications of ethical decision making principles reinforce learning during the introduction learning for the course. Connections are made to each of these cases throughout the semester as new material enables in an effort to equip students to deal with situations they will encounter in daily business life.

Business 20 Introduction to Business – general overview of business and integration of topics

One week is devoted solely to ethics and social responsibility. This includes philosophical basis of ethical norms, ethical decision making process utilization, and case studies in social responsibility.

Business 22 Human Behavior & Leadership – Team work and management from a human behavioral approach

One full class is devoted to ethics to cover a chapter on ethics. The approach focuses on ethical approaches to leadership, specifically the treatment of the multiple stakeholders affected by leaders' decisions.

Business 24 Business Issues And Ethics – Directly addresses business ethics, not a subtly embedded course

Three semester units cover the ethical issues, moral philosophies, social responsibility, ethical decision making, organizational culture, business relationships, conflict management, developing effective ethics programs, global business ethics, ethics and performance, and ethical marketing practices. Case studies enable students to practice ethical concepts in the ethical environment being studied.

Business 30 Global Management – International business survey course

Ethical issues involving trade & subsidies taught using cases studies and discussion forum.

Business 36 Introduction to International Marketing -

Ethics, corruption, unfair trade policies, protectionism, child labor, impact of multinationals on third world economies.

Business 38 Multiculturalism in Corporate America -

Ethical norms of several different populations within American business are explored though case studies and role playing in a corporate environment. Non-discriminatory practices include raising awareness of stereotyping and prejudice as compared to treatment based on individual's contribution and competency.

Overview of California community college ethical studies:
California community colleges offer a variety of ethics courses. I reviewed about 30 schools, and found that Accounting programs vary from requiring no ethics at all, to offering optional ethics courses in specialty areas, to requiring an ethics course as part of a certificate or degree program. Other specialty studies offer ethics courses tailored to their area of study, eg Police ethics. Community colleges provide both terminal skills training and transfer preparation. Equipping ready-to-work Community college graduates with some ethical decision making education is important because this may be the only formal ethics training they will get. The practicality of including ethics in the first two years of study for transfer students suggests that a University accounting program may well be able to include ethics content in lower division courses of their programs.

List and descriptions of ethics learning opportunities available at community colleges:

Philosophy program: Introduction to Ethics

> These courses are typically part of general education requirements. They deal with ethical theory and extend to ethical decision making processes as well. Context does include some business situations, but also others such as personal, historical, current societal directions, legal, etc.

Business department: Business Issues & Ethics, Professional ethics, Business morality, etc.

> These more specialized courses share many of the same philosophical roots of the general ethics classes, but they are focused more heavily within the context of business. Here, a hands-on emphasis of practical ethical decision making processes seems to be the point, versus the more theoretical approach of the general philosophy ethics courses.

Specialty area ethics courses: Computer ethics, Health care ethics, Fire ethics, Police ethics, Financial sales ethics, Hacking ethics, etc.

> These are highly specialized courses dealing in ethics, law, and other specific situations involving the specialty subject. These typically involve industry specific legal issues, changing ethical norms, and other nuances important to just these specialty areas. Interestingly, I still have not found a pure accounting ethics course in the several community colleges I've investigated.

Non-Ethics courses involved in building ethical decision making ability

> Business Law: This course covers legal principles to provide a baseline assessment of appropriate behavior
>
> Philosophy, Critical thinking: This course builds skills in situation assessment, logical decision making processes, and effective communication
>
> Humanities/English/Business communication: Communication courses ranging from reading and writing to effective negotiation and presentation skills all contribute to an individual's ability to effectively make the case for their position and pursue their ethical path of choice.
>
> Fraud Examination: This course exposes students to common fraud schemes, how to uncover them, and how to prevent them – key elements in choosing not to participate in the fraud.
>
> Business Philosophy: This course reviews writings of historical business thinkers providing a basis to analyze competing philosophies and understanding of alternate perspectives as justification for ethical decision making. (Note: I haven't seen this class anywhere, I've only reviewed the text.)

Supporting materials: Course descriptions, where different or unique, were copied from either Cirricunet.edu or online school catalogs. This is not an exhaustive listing, it is only sampling of unique or representative courses.

CA Victor Valley College --- CIS 50 -- Computer Ethics
Credits\Units: 2
Description: Computer Ethics is an introduction to the theories and issues of ethical behavior as applied to the exigencies of a rapidly changing, information- oriented, computer-driven society. Topics include ethical history, philosophies, and issues at the responsibility level of both corporate business and the individual. Various ethical theories are introduced and discussed. Numerous current and past case histories are presented.

CA Cypress --- PHIL 160 C -- Introduction to Ethics
Credits\Units: 3
Description: UC/CSU, AA GE, CSU GE, IGETC, CAN PHIL 4 This course is an introduction to metaethics, normative ethics, and applied ethics. Fundamental ethical concepts, theories, and arguments in classical, medieval, modern, and contemporary ethical thought are presented, analyzed, and critically evaluated.

IL Dupage --- HLTHS 2211 -- Legal and Ethical Aspects of Health Care
Credits\Units: 0 - 3
Description: Legal and ethical aspects of health care with an emphasis on patient's rights, confidentiality, case law, code of ethics, documentation, consent, release of information and accreditation standards as they apply to medical assisting.

CA Cypress --- PHIL 165 C -- Business & Professional Ethics
Credits\Units: 3
Description: This course examines the major ethical issues that arise in contemporary business practices, e.g., preferential treatment for underrepresented groups, responsibility to the environment, codes of conduct for professional persons, sexual harassment, and the morality of strikes by public service personnel. The course considers leading normative ethical theories and the ways they have been applied by ethicists to provide solutions to the ethical problems that arise in business. It also emphasizes the development of logical skills necessary for critically evaluating arguments that have been given for and against the solutions proposed to ethical problems that arise in business. Pass/No Pass/Letter Grade Option.

CA Palomar --- FIRE 142 -- Fire Ethics
Credits\Units: 3
Description: Fire ethics will be studied from the perspective of a professional firefighter. Students will examine and explore ethical and moral dilemmas that will confront Firefighters/EMS personnel throughout their career.

Glendale CC

ACCTG 235 - 3.00 - FRAUD EXAMINATION

Description: ACCTG 235 is an advanced course that addresses the principles and methodology of fraud detection and deterrence. The course includes such topics as skimming, cash larceny, check tampering, register disbursement schemes, billing schemes, payroll and expense reimbursement schemes, non-cash misappropriations, corruption, accounting principles and fraud, fraudulent financial statements and interviewing witnesses.

CA Ventura College --- IDS 08 -- Ethics in Modern Society
Credits\Units: 3
Description: This course provides an introduction to the philosophy of ethics in our modern-day society. It integrates ethical issues from areas such as environmental studies, bioethics, criminal justice, business and law, the media, literature, medicine, politics, theater, and from the field of psychology. In addition to lectures and discussions in each of these areas, movies, videos, and a theatrical production may be included to help illustrate specific ethical issues.

CA Palomar --- AJ 106 -- Police Ethics
Credits\Units: 3
Description: Designed to enable the student to explore and understand the potential ethical dilemmas that may confront administration of justice professionals. Morality, ethics, justice and law will be studied from the perspective of a criminal justice professional.

CA Palomar --- INS 125 -- Insurance Code and Ethics
Credits\Units: 1
Description: The study of Article II, 4. of the University Risk Management & Insurance Association, which covers a statement of ethics and standards of professional conduct for member representatives. The principles for the development of a systems approach for making ethical business decisions is reviewed. Such a methodical process provides for selecting alternatives that are responsible, practical, and defensible.

CA Fresno City College --- BA 58 -- Business Morality and Ethics
Credits\Units: 1.5
Description: Applied business ethics and its relationship to free markets, marketing, finance, and the law. Topics cover key issues including management’s responsibility for accountability, corporate governance, accounting practices, stakeholder relations, and ethical decision.

CA Cypress --- HSCE 250 C -- Radiation Laws and Ethics
Credits\Units: 3
Description: Content is designed to provide an overview of the principles of the interaction of radiation with living systems. Radiation effects on molecules, cells, tissues, and the body as a whole are presented. Factors affecting biological responses are presented, including acute and chronic effects of radiation. The course is designed to present the principles of radiation protection including the responsibilities of the radiographer for patients, personnel, and the public. Radiation health and safety requirements of federal and state regulatory agencies, accreditation agencies, and health care organizations are incorporated. An introduction to legal terminology, concepts, and principles will be presented. Topics include misconduct, malpractice, legal and professional standards and the scope of practice. The importance of proper documentation and informed consent is emphasized. The student will examine a variety of ethical issues and dilemmas found in clinical practice.

IL WILLIAM RAINEY HARPER COLLEGE --- NET 283 -- ETHICAL HACKING
Credits\Units: 3
Description: Provides students with hands-on experience using penetration tools and techniques to test and protect computer networks. Topics include network and computer attacks, footprinting, social engineering, scanning, enumeration, cryptography, operating system and device vulnerability, and related ethical considerations. NOTE: A criminal background check is required.

AB SAIT POLYTECHNIC --- BFIN 353 -- Financial Selling and Ethics
Credits\Units: 3
Description: This course focuses on the use and demonstration of a Needs Satisfaction Selling model. Through financial product-based role plays, participants will employ all elements of the model including developing rapport, determining client's needs, explaining features and benefits and overcoming objections. Ethics in selling will be introduced. Participants will prepare and deliver a sales presentation.

CA Palomar --- PHIL 100 -- Philosophical Theories-Ethical and Political Values
Credits\Units: 3
Description: An introduction to philosophical thinking through the study of ethical and political values using a combination problem and historical approach. Relations between philosophical problems and those of science, society, and ordinary life are stressed. Both classical and modern reading sources are used.

Los Rios

ACCT 361 Ethical, Legal, and Professional Standards in Accounting 3 Units

Advisory: ACCT 107 and 301
Course Transferable to CSU
Hours: 54 hours LEC
This course explores the legal and ethical issues that must be addressed by accountants. Topics in ethics include ethical foundations as well as the unique ethical requirements of professional organizations and the California Board of Accountancy. Topics in law include legal liability of accountants, contracts, sales, negotiable instruments, documents of title, secured transactions, debtor and creditor relationships, agency, federal securities regulation, other regulations, and property law.

Peralta - Berkey City College:

This course is required for their AA in Accounting. It seems to be in there for people problem solving, bordering on ethical decision making?

BUS 5, 3 Units
Human Relations in Business
3 hours lecture (GR). Acceptable for credit: CSU
Application of behavioral science concepts to human problems in organizations: Action necessary to prevent and resolve problems among individuals within groups; application of logical decision-making techniques.

Butte College

BUS 8 - Legal Environment of Business 3 Unit(s)
Recommended Prep: Reading Level IV; English Level III; Math Level II
Transfer Status: CSU/UC 51 hours Lecture
This course covers laws and regulations affecting managerial decisions including legal concepts and case analysis in the areas of ethics, employment, consumer transactions, competition, the environment, business torts and crimes, contracts, agency and business organizations.
BUS/BCIS 13 - Business Communication 3

Cabrillo College – in addition to US business law, they also offer this international course.

BUS 68
International Business Law
4 units; 4 hours Lecture
Recommended Preparation: Eligibility for ENGL 100 and READ 100.
Introduces international business and environmental laws and their utilization in creating and executing effective corporate strategies and international business transactions. May be offered in a Distance-Learning Format.
Transfer Credit: Transfers to CSU.

Feather River College: An example of industry specific ethics training as an option within program of study.

BUS 117 CODES & ETHICS 1 UNIT
Hours: 18 lec.
Designed for insurance majors, addresses ethical considerations one must support in order to succeed in business, specifically in the insurance industry. Presents ethical issues that employees encounter in insurance offices.

Mira Costa College: Another instance of HR being offered within accounting, either this or business law satisfies.

136 H uman Relations in Business 3 Units
Prerequisites: None
Acceptable for Credit: CSU
Lecture 3 hours. (0506.00)

Topics include motivation; values; attitudes; group behavior; teamwork; communication; productivity; total quality; job redesign and enrichment; leadership; developing, appraising, and rewarding employees; and managing conflict and change.

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CALIFORNIA STATE UNIVERSITY, EAST BAY

To: Cindi Fuller, Renewal and Continuing Competency Unit Coordinator

From: Gary McBride **Dec. 8, 2010**

Re: ECC Research on Embedded Ethics at CSU East Bay and Related Issues

Can first time freshman Alice, seeking a B.S. in Business (Accounting Option) at CSU East Bay graduate with no more than 180 quarter units (equal to 120 semester units) and satisfy a requirement for 15 quarter units in ethics (equal to 10 semester units) consistent with the broad "ethics study guidelines," as defined in California B&P Code Sec. 5094.6(e)(2)? Yes. For simplicity, the following discussion ignores the fact that Alice could complete additional ethics units (in graduate level classes) as part of the additional 45 units (equal to 30 semester units) that she would need to satisfy the "150 hour" requirement. The following four undergraduate courses (4 units each) appear to satisfy the statute (detailed course descriptions are included below):

(1) Accounting 4911: *Ethics, Regulation and Financial Statement Fraud*
(2) Management 4500: *Business, Government, and Society*
(3) Philosophy 3560: *Business and Professional Ethics*
(4) Philosophy 2002: *Introduction to Ethics*

Definition of "Ethics Study Guidelines"

The statutory mandate to the Ethics Curriculum Committee is to recommend to the board "ethics study guidelines" consisting of no less than 10 semester units. "Ethics study guidelines" are defined in California B&P Code Sec. 5094.6(e)(2) as "a program of learning that provides students with a *framework* of ethical reasoning, professional values, and attitudes for exercising professional skepticism and other behavior that is in the best interest of the investing and consuming public and the profession. At a minimum, it ….shall include a *foundation for* ethical reasoning and the core values of integrity, objectivity, and independence consistent with the International Education Standards-4 of the International Accountants Education Standards Board, …." (Emphasis added).

The Four Courses

Three upper division courses. The following three upper division courses could all be completed by Alice in conjunction with her regular upper division coursework.

Acct 4911: *Ethics, Regulation and Financial Statement Fraud*

> *Ethical, legal, regulatory issues and social responsibility in context of financial statement frauds such as Enron. Role of SEC, impact of Sarbanes-Oxley. Corporate governance and related professional responsibilities in protection of consumers, investors, and other stakeholders.*

Acct 4911 can be taken as an accounting elective. It obviously involves ethics issues that relate directly to the accounting profession. The International Education Standards 4 (IES 4) stresses the need for students to “understand the values, ethics and attitudes that run through everything that professional accountants do and how they contribute to confidence and trust in the market”. IES 4 also refers to the desirability of education programs that explore links between “ethical behavior, corporate failure and fraud.”

Mgt 4500: ***Business, Government, and Society***

> *The relationships between business managers and the social, economic, and political environment within which they operate; business ethics, antitrust policy, social responsibility, and consumer protection.*

Management 4500 is a core business class generally required of all business majors. It provides a foundation for ethical business decision making. IES 4 notes that “[s]ince professional accountants have a role to play in decision making, they need to have a thorough appreciation of the potential ethical implications of professional and managerial decisions.”

Phil 3560: ***Business and Professional Ethics***

> *Team-taught by a philosopher and a social scientist. Explores current ethical issues in business and other professions: preferential hiring vs. equal opportunity, environmental regulation vs. property rights, truthfulness in business communications, economic efficiency vs. social responsibility.*

Philosophy 3560 is a popular elective core business course at CSU East Bay because it meets a core business requirement and also a general education requirement. As with Management 4500, this course is not specifically aimed at the accounting profession, but it provides a foundation for ethical reasoning and business decision making.

One Lower Division General Education Ethics Course

For Alice to complete 16 units of ethics, she would also need at least one lower division general education course in ethics.

Phil 2002: ***Introduction to Ethics***

> *Introduction to philosophical ethics. Topics include major ethical theories, virtue, vice, evil, character, moral education and relativism. Impact of cultural diversity on ethical discourse.*

Given the need for a *framework* for ethical reasoning, this introductory course apparently falls within the ethics study guidelines. Numerous other GE courses deal with ethics, for example:

Phil 1101: ***Contemporary Social and Ethical Issues***

Topics of contemporary concern, e.g., human rights, roots of social injustice, affirmative action, sexism and racism.

Phil 1102*: Issues in Environmental Ethics*

Critical examination of ethical issues in environmental philosophy. Topics may include: the impact of human activity on environmental systems, climate change, loss of biodiversity, sustainable practices, and intergenerational justice.

Embedded Ethics Units

Numerous other business, accounting, and tax classes have ethics elements embedded.

Because the identification of embedded ethics coverage is not currently required, no effort has been made by the instructor to quantify the proportion of the course devoted to ethics. Many new accounting textbooks (particularly for the introductory accounting courses) enable an instructor to monitor the percentage of the exams that are devoted to ethics questions. The instructors I spoke to indicated that ethical issues are covered in the introductory accounting classes.

I spoke to the Dean of our College about the possibility of ethics coverage (within a course) being reflected on a student's transcripts and I learned that the transcript only lists courses (not segments of courses).

Identifying segments of courses as meeting the ethics requirement, to the satisfaction of the California Board of Accountancy, will be challenging. However, the challenge is probably worth overcoming given the importance and value to the student, and the profession, of covering ethics issues as an integral part of the coverage of substantive accounting and tax issues.

If proof of ethics units embedded within a course--to the satisfaction of the California Board of Accountancy--is impossible or impractical, then perhaps the ECC could establish guidelines that encourage (but do not require) the development by colleges of accounting specific 1 or 2 unit ethics courses. The documentation problem would be solved because the course title and related units would be reflected on the student's college transcript. For example, the CSU East Bay graduate tax class for Tax Research, Procedure and Penalties (Acct 6223) could be divided into two courses: one course (1 or 2 units) covering ethics and penalties and a second course (2 or 3 units) dealing with tax research and procedure. Both courses would be reflected on the student's CSU East Bay transcript.

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CAL POLY, SLO

Dominic Franzella

Subject: FW: Ethics in the Curriculm
Attachments: Mintz Text.pdf; Cal Poly.pdf

-----Original Message-----
From: Steven M. Mintz
Sent: Wednesday, November 03, 2010 5:54 AM
To: CFuller
Cc: ddriftmier; Dominic Franzella
Subject: Ethics in the Curriculm

Cindi:

Dominic asked members of the ECC to provide information on how ethics is covered in our respective curriculums. I have attached two files. One (Cal Poly) contains a survey of ethics coverage in the Cal Poly curricula. The other (Mintz Text) includes the detailed table of contents from the second edition of my accounting ethics text. The book is used in the stand-alone accounting ethics course at Cal Poly and at about 40 other colleges and universities especially those in Texas. I thought the group would benefit from seeing the kinds of topics that can be included in an accounting ethics course.

Please let me know if you need any additional information from me.

Steve

Courses where Ethics is taught in the COB CAL POLY, SLO
January 19, 2009

Faculty Responding	Class where taught e.g. (BUS 215)	Amount of time spent covering such issues (hours per course)	Examples of how ethical issues is/are covered (Attach documentation if appropriate)
Polly Mead	214	1	Internal controls, fraud, transparency lecture
Stern Neill	BUS418	1 hour (.5 lecture/ .5 application)	Discussion and application of *informed consent* • Participants understand who you are and the purpose of class project • Participants understand what their involvement entails • Participants are given assurance of privacy and confidentiality • Participants understand that they may withdraw • Participants consent to their involvement Discussion and application of *researcher's role* Emotional, ethical and political sensitivity
Steve Mintz	BUS 424	8	Philosophical reasoning; Ethical Decision Making
Steve Mintz	BUS 424	6	Ethics in Business; Corporate Governance; Corporate Social Responsibility
Steve Mintz	BUS 424	12	Ethics in Accounting: Code of Ethics for CPAs; Ethics of Auditing; Fraud in Financial Statements
Steve Mintz	BUS 424	4	Legal liabilities of CPAs; Relations between being ethical and following the law
Steve Mintz	BUS 424	10	Earnings Management; Techniques used to "cook the books"
Jim Sena	Bus 382	25% of course	Work (diversity); The Corporation (legal person); McDonalization of Society; Cultural issues; Technology issues (mobile work, outsourcing,..); Environment (energy policies,..)
Jim Sena	Bus 401	40% of course	Industries include Fast Food, Beverage (Bottling), Tobacco, Delivery, Auto, Grocery Store, Wal-Mart, Internet, Starbucks, Gambling (Casinos)…) also lectures on Control and Ethical Behavior
Dan Villegas	ECON 201	2 hrs./ quarter	pollution control, poverty and income distribution
Dan Villegas	ECON 303	Entire course involves ethical issues	Value systems: including utilitarianism, legal and moral rights, distributive justice and ethics of care; We also cover issues related to ethics such as the causes of poverty, the advantages and disadvantages of an unequal distribtution of

			income, the source and costs of discrimination, and the costs and benefits arising from immigration.
Wiley Poole Marketing Adjunct	Bus 346	These issues are also discussed sporadically throughout the quarter so the total time spent is approximately 4 hours.	. During the course I have one session completed devoted to Ethics in Advertising, primarily about social responsibility (privacy concerns) and corporate social responsibility ("green/environmental" concerns). This is a verbal discussion with the class at large using current news articles as the genesis of the conversation.
Tad Miller	BUS 319	1.0 hour	A chapter in the text on professionalism
Tad Miller	BUS 321	0	Not covered
Tad Miller	BUS 425	2.0	A chapter in the text on Professional Ethics. This material is presented using the framework of professional ethics as developed by the AICPA. Aspects of this material weave their way throughout the entire course.
Eric Fisher	Econ 330, International Trade	¼ of the time	Basically all of international economics is aimed at understanding the philosophical underpinnings of laissez-faire capitalism
Eric Fisher	Econ 404	¼ of the time	Basically all of international economics is aimed at understanding the philosophical underpinnings of laissez-faire capitalism
Jack Robison	BUS416	1-2	Their ethics in working on projects, ethics in taxation, dealing with clients who wish to take unethical positions on their tax returns
Lee Burgunder	BUS 404	4+	I cover corporate social responsibility and ethical issues. I spend a week exclusively on CSR. The rest of the course deals significantly with regulation; which often involves government responses to unethical or socially irresponsible conduct, such as with product safety, insider trading, antitrust matters, FTC regulation of deceptive practices. I do not know how to quantify the time of this coverage
Lee Burgunder	BUS 311	Difficult to quantify	legal and regulatory issues that often are responses to unethical conduct, such as file sharing, trade secret misappropriation, deceptive domain name practices, etc
Lee Burgunder	BUS 410	20 hours	case studies, homework problems, lectures, group activities, discussions, test questions
Lee Burgunder	BUS 473	15 hours	case studies, in class discussions, lecture, test questions
Roger Bishop	BUS 215		No formal discussion or presentation of ethics. Only in the course of class discussion whenever I am able to make a point regarding business ethics, particularly as they apply to accountants and financial planners/advisors, I do
Kathryn Marshall			None
Rebecca Ellis	BUS 384	30 minutes	Corporate Social Responsibility as a Business

			Objective (lecture on Environmental Challenges)
Rebecca Ellis	BUS 384	3-4 hours	Managing diversity; social dimensions of EEO law (two lectures, two cases and two in-class exercises)
Rebecca Ellis	BUS 384	1 hour(two half hour segments)	Two exercises on different days: Ethical dimensions of Performance Appraisal; Ethical Dilemmas in Compensation (emphasis on ethical business decisions)
Richard Carter	BUS-391	2	Ethical use of information.
Richard Carter	IT-371	2	Data analysis re: per capita carbon footprint; natural capitalism
Bonnie Woodson, Ed.D.			I feel it is critical in today's business environment to cover ethics and social responsibility in all of the courses that I teach. So I spend at least 1/2 class period or more on this topic. I also use ethical behavior assessments as well as ethical dilemma cases for discussion. Without getting too detailed, I've had many student debates on ethical topics in which the students take very strong positions. I believe it is one thing to talk about it--but an entirely different thing to act or behave in a manner that supports one's position (Type II ethics)-- living in an ethical manner. If you have any questions, please let me know.
Michelle Bissonnette	Bus 214		Amount of time spent covering such issues (hours per course)? Hard to say, I do not have a chapter assignment specifically related to ethics, but I discuss ethical issues on a regular basis related to filing public documents, honesty and integrity, problems in the industry, lack of regulation, etc. However, I do have a chapter assignment on internal control. Class room discussion and homework assignments related to types and problems related to lack of internal controls.
Michelle Bissonnette	Bus 320		Amount of time spent covering such issues (hours per course)? Similar to above. I do not have a chapter assignment specifically related to ethics, but I discuss ethical issues on a regular basis related to honesty and integrity, tax evasion vs. tax avoidance. I spend a fair amount of time discussing social responsibility and the use of tax dollars. Almost every chapter students ask questions of ways to evade/avoid taxes, so this is an ongoing topic of conversation in tax.
Kate Lancaster	BUS 215	6	1 hour conversation on business ethics facilitated by class discussion of current articles that illustrate ethical or unethical behavior 2 hour conversation around Introduction to Sustainability: The Business Case for Sustainability presentation I developed and give. 3 hours interspersed with examples.
Kate Lancaster	GSB 511	6	1 hour conversation on internal controls 2 hour conversation around Introduction to

			Sustainability: The Business Case for Sustainability presentation I developed and give. 3 hours interspersed with examples.
Kate Lancaster	BUS 470	10	Sustainable business considers the ethical consequences that occur along the value chain.
John Dobson	BUS 342	1	CSR
Bill Pendergast	BUS302	2-4 hours	One class on Ethical Frameworks (ie, ontology, teleology, etc); One class on Bribery & Corruption in international business.
Bill Pendergast	BUS303	2 hours	One class on International Corporate Social Responsibility
Steven Stern	BUS 207, BUS 308 and BUS 404	Minimum of 2.5 classes and usually in one way or another in every class during the quarter	I assign law cases focusing on human rights, ethics and social and business responsibility. I also assign research projects on various individuals and entities related to violations of human rights, ethics and social and business responsibility. I also assign readings on these topics from the textbook, and have assigned additional books focusing on the impact of commerce on the environment, and manipulation by corporations and international organizations on third world countries (people, raw materials, pollution, et.al.). All of the above are discussed in class by the different individuals/groups assigned. Additionally, I prepare hypotheticals focusing on various types of ethical issues for the students to identify, true and false and multiple choice questions, and have the student take an ethics quiz, which they submit anonymously and I tally and the share the results with the class.

Syllabus Provided by:

Steve Mintz

Second Edition

ETHICAL OBLIGATIONS AND DECISION MAKING IN ACCOUNTING

Text and Cases

Steven M. Mintz

Roselyn E. Morris

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CALIFORNIA BOARD OF ACCOUNTANCY

DEPARTMENT OF CONSUMER AFFAIRS
CALIFORNIA BOARD OF ACCOUNTANCY
2000 EVERGREEN STREET, SUITE 250
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DIABLO VALLEY COLLEGE

Dominic Franzella

Subject: FW: Ethic Courses REsearch
Attachments: DVC-Ethics Review For CPA Licensure.docx

From: [redacted]
Sent: Friday, December 03, 2010 7:01 PM
To: Cindi Fuller
Cc: Dominic Franzella
Subject: Ethic Courses REsearch

Dear Cindy,

Attached is the document that reviews the Ethics Research at Diablo Valley College in both the Business Division and across other areas of the campus. I broke out the document in two parts: The first part lists courses where ethics is embedded regardless if the course description has the word "ethics" as part of its description. The second part lists courses at Diablo Valley College only if ethics is easily and clearly noticeable from the description because the word "ethics" is used in the description.

I learned a great deal through this exercise in that our college and department will need to update descriptions to utilize how ethics is embedded in the courses so that licensure boards can clearly identify whether or not the course meets the ethics requirement. We will be having those discussion early part of next year. We are seeking, as I am sure other colleges and universities are, a definition of ethics as a framework so that student learning outcomes can be published and measured as well as having the description of the course updated with the word "ethics".

Let me know if you have any questions.

See you on January 26!

Best Regards,
Gary Pieroni

DVC
DIABLO VALLEY COLLEGE

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321 Golf Club Road
Pleasant Hill, CA 94523
Tel: 925-685-1230, ext. 2319
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Diablo Valley College

Part 1: Ethics Embedded in Business Courses (but not necessarily identified in course description)

Level	Department	Instructor	Ethics Definition and Methods
Lower	Bus 250 (Business Com)	Seefer, Carolyn	Employment communication (resume, application letters, interviews) 5%
Lower	Bus 255 (Business Com 2)	Seefer, Carolyn	Sales letter, proposals, advanced communication: chat, websites,
Lower	BusAc186 (Accounting I)	Pieroni, Gary; Murphy, Tim	15% (Internal control, fraud, accounting procedures, basis of information systems , differences between rules-based and framework approaches to ethics)
Lower	BusAc187 (Accounting II)	Pieroni, Gary; Murphy, Tim	Management Decision Making Models and Issues (5%)
Lower	BusAc190 (Payroll)	Staff	75% (Responsibility of accountant as a fiduciary in a trust environment)
Upper	BusAc282 (Intermediate Acctg)	Pieroni, Gary	Reporting Issues regarding shareholder value and Financial Statement influences, cost of borrowing, criminal proceedings and licensure suspension/termination.
Upper	BusAc283 (Auditing)	Staff	85% (Auditor's responsibility in maintain independence; legal requirement to detect fraud.)
Upper	BusAc285 (Fed Inc Taxes)	Murphy, Tim	Perspectives on tax savings and tax planning techniques within the legal framework.
Upper	BusAc190J (International Acctg)	Susich, Robert	60% (International accounting principles vs. US Rules based)
Lower	Philo120 (Philosophy)	Abele, Bob	Value Theory (ethics and aesthetics)
Lower	Philo122 (Philosophy)	Abele, Bob	Major ethical theories, moral reasoning, evaluation of moral issues such as abortion, euthanasia, and capital punishment.
Lower	Philo220 (Philosophy)	Staff	Religious thought, experience and ethical teaching of living religions of the world examined, discussed and compared.
Lower	BusMk255 (Advertising)	Laham, Martha	*See Description below
Lower	BusMk256 (Marketing)	Laham, Martha	*See Description below
Lower	Bus109 (Intro to Business)	Laham, Martha; Winkler, LoAnn	*See Description below
Lower	Bus101 (Business English)	Foster, Judy	5%(values in dealing with "uncomfortable" situations; responsibility, privacy/confidentiality issues, professional behavior; resolution of uncomfortable situations.)
Lower	RE160 (Real Estate Principles)	Young, Monique	10% Code of Ethics; Department of Real Estate rules and regulations
Lower	RE161 (Legal Aspects of RE)	Young, Monique	35% (standard professional practice between licensees and public; cases from Ethics Committee of local RE board; National Association of Realtors' Code of Ethics; DRE rules and regulations;
Lower	Bus294 (Business Law)	Simmons, Ronald	35%(ethical theories: normative ethics, consequentialism, rationalism, social justice theory, profit maximization, stakeholder theory, Sarbanes Oxley, Federal and State statutes re: whistle blowing.

*The public interest and sensitivity to social responsibilities; Reliability, responsibility, and courtesy; laws and regulations; concepts of skepticism, accountability and public expectations; relationships between laws, regulations and public interest; ethics and the individual profession, ethical dilemmas and their resolution.

Part 2: Courses with Catalogue Descriptions That Mention Ethics

Area: Accounting Courses

Note: Blue highlighted and underlined areas "imply" ethics";
Yellow highlighted areas explicitly mention ethics.

BUSAC-186 Principles of Accounting I

A theory and procedures course required for many business administration and accounting majors. Introduction to fundamental financial accounting principles, theory, concepts and procedures as the basis of an information system. Includes the role of financial information in business decisions, basic financial statements and the processes used to prepare these financial statements.

BUSAC-282 Intermediate Accounting

An advanced level financial accounting course that reviews and builds on the foundation material presented in Principles of Accounting I. Emphasizes financial accounting concepts and reporting issues in association with financial statement preparation and interpretation.

BUSAC-283 Auditing

This is an intermediate level course on the role and responsibility of Certified Public Accountants in the audit of financial statements. Emphasis will be placed on verification of balance sheets and internal control of accounting systems and cycles. Topics include sampling techniques, auditing standards, and professional ethics, legal liability, audit reports, and audit programs.

Area: Management Courses

BUSMG-120 Introduction to Management Studies

This course is designed as an introduction to the skills and applications used in modern management practice. Topics may include foundation of management principles, planning, organizing, staffing, directing, controlling, legal, ethical, and social responsibilities of management.

BUSMG-131 Gender Issues in Management

An exploration of gender issues in management resulting from the expansion of women's roles at work during the past decades and the growth of the multicultural workforce. Leadership styles, use of power, mentoring, networking, communicating, teamwork, discrimination, sexual harassment and family/work balance will be studied in the context of the current diverse workplace.

BUSMG-132 Human Resource Management

A comprehensive study of human resource management in organizations, including human resource planning; employment legislation; recruitment and selection; training and development; compensation and benefits; performance appraisal and career management; managing labor relations; safety, health, and well-being; and motivation and enhancing performance. The course will explore topics including values, ethical issues, leadership and communication, conflict, work design, and organizational culture.

Area: General Business Courses

BUS-250 Business Communications I – Taught by Carolyn Seefer

A course designed to help students develop the skills necessary to communicate effectively in a professional business environment. The focus will be on communicating clearly, concisely, considerately, and correctly, both orally and in writing. Students will learn to prepare basic business documents, including letters, memos, short reports and proposals; to use technology to communicate, including email and discussion boards; and to prepare and deliver short oral presentations. The course will also contain an introduction to employment communication, including resumes, application letters, and interview skills. Emphasis throughout the course will be placed on intercultural communication and the ethics of communication.

BUS-255 Business Communications II – Taught by Carolyn Seefer

An advanced course designed to help students continue to develop and refine skills necessary to communicate effectively in a professional business environment. The focus will be on communicating clearly, concisely, considerately, and correctly, both orally and in writing. Students will learn to prepare advanced business documents, including sales letters, proposals, and research reports; to use advanced technology to communicate, including mailing lists, virtual chat rooms, basic Web site development, and audio- and videoconferencing equipment; and to prepare and deliver complex multimedia presentations. The course will also contain segments on documenting resources properly; conflict resolution; negotiation techniques; meeting management; and utilizing the Internet for job searching and networking. Emphasis throughout the course will be placed on intercultural communication and the ethics of communication.

Area: Business Information Technology Courses

BUSIM-211 Office Procedures and Technology

A comprehensive course covering the essentials that office professionals must know to succeed in a professional office environment. Students will study all aspects of administrative office work and complete projects that simulate common office situations using various software packages, office equipment, and the Internet. Students will learn how to communicate effectively, process financial information, greet customers, handle multiple phone lines, operate standard office equipment, manage files, process mail, make travel arrangements, plan meetings, and use the Internet for business research and communication. Special emphasis will be placed on professionalism, ethics, communication, and career management.

Marketing Courses with Topics in Ethics

BUSMK-255 Advertising

A study of the historical, social, ethical, economic, and regulatory aspects of advertising. The subject evaluates advertising, media, and creative strategies for traditional and electronic markets. Topics include effects of consumer behavior patterns, the client-agency relationship, and the development and evaluation of advertising campaigns.

BUSMK-256 Marketing

Introduction to marketing functions involved in facilitating the exchange of goods and services. Focus on the analysis of markets: assessment of the marketing environment; formulation of marketing strategy; and development of the marketing mix variables of product, price, promotion, and distribution. Ethical issues considered.

Area: Philosophy Courses

PHILO-120 Introduction to Philosophy

This course carefully and critically examines the most basic of human beliefs. Logic, epistemology, metaphysics, value theory (ethics and aesthetics), and philosophy of religion are explored at an introductory level. The vocabulary of philosophy and techniques of inquiry are included.

PHILO-122 Introduction to Ethics

This course is a systematic examination of major ethical theories, the nature of moral reasoning, as well as the evaluation of contemporary moral issues such as abortion, euthanasia and capital punishment.

See details...

Diablo Valley College Course	
PHILO-122: Introduction to Ethics	
Description	
This course is a systematic examination of major ethical theories, the nature of moral reasoning, as well as the evaluation of contemporary moral issues such as abortion, euthanasia and capital punishment.	
Recommended	
Eligibility for ENGL 122 or equivalent	
General Information	
Department:	Humanities and Philosophy
Division:	Applied and Fine Arts
Units:	3.00
Grade Code:	Student choice
Repeatability:	0
Max day class size:	42
Max night class size:	45
Number of Hours	
Per Semester	
Lecture:	54.00
Laboratory:	0.00
Activity:	0.00

By Arrangement

Lecture:	0.00
Laboratory:	0.00
Activity:	0.00

Objectives

Students will be able to:

A. Describe the nature of and justification of ethics.
B. Recognize ethical issues in decision-making.
C. Assess traditional and contemporary ethical positions.
D. Analyze ethical issues from the perspective of different ethical theories.

Content

A. What are ethics?
1. Customary morality and reflective morality
2. Descriptive, normative and meta-ethics

B. Ethical relativism
1. Descriptive relativism
2. Normative ethical relativism
3. Meta-ethical relativism
4. Ethical absolutism

C. Egoism
1. Psychological egoism and ethical egoism
2. Arguments for and against psychological egoism
3. Arguments for and against ethical egoism

D. Utilitarianism
1. Two kinds of ethical systems
2. Utility as the test of right and wrong
3. Act utilitarianism and rule utilitarianism
4. Arguments for and against utilitarianism

E. Ethical Formalism
1. Teleological and deontological ethics
2. Kantian ethics

F. Intrinsic value
1. The right and the good
2. The concept and intrinsic value
3. Hedonism
4. Pleasure and happiness

G. Moral responsibility and Free Will
1. Excusing conditions
2. Determine and excusability
3. Libertarianism
4. The compatibilist concept of freedom
5. Soft determinism and hard determinism
6. Moral responsibility

H. Values and Facts
1. Naturalism and unnaturalism
2. The naturalistic fallacy
3. Noncognitivism
4. Standards of evaluation and the meaning of �good�
5. Descriptivism

Methods

Lecture, Discussion, Small group presentations

Assignments	
Reading 1:	Read the chapter about morality and religion. What is the Divine Command theory?
Reading 2:	Read the chapter on cultural relativism. What are the consequences of taking cultural relativism seriously?
Writing, problem solving, performance 1:	Discuss the issue of civil disobedience from the perspective of Rawls, Martin Luther King, and Socrates.
Writing, problem solving, performance 2:	Write a two-to-three page essay contrasting a Kantian and Utilitarian view of capital punishment. Evaluate each perspective.

Evaluation	
Sample One:	Compare and contrast psychological egoism and ethical egoism. Evaluate several arguments that defend and/or criticize each theory.
Sample Two:	Discuss the moral principle of utilitarianism. Compare and contrast the views of Mill and Bentham. With whom do you agree? Why?
Frequency of Evaluation:	Evaluations will adhere to the DVC "Fairness in Grading" guidelines and will include as a minimum: • Evaluation of students within the first quarter of the course and notifying student of the results • Counting a final examination for no more than one-half the course grade • Basing final grades on at least three students' tests and/or reports Additional: Plus specifics provided by the initiator, for example chapter quizzes, 1 mid-term, etc.

Sample Textbook. See the current course syllabus or bookcenter.dvc.edu for the actual course textbook.	
Book One	
Author:	MacKinnon, Barbara

Title:	Ethics: Theory and Contemporary Issues, 6th Ed.
Publisher:	Wadsworth
City:	Belmont, CA
Year:	2008
Book Two	
Author:	Rachels, James
Title:	Elements of Moral Philosophy 6th Ed.
Publisher:	McGraw-Hill
City:	New York, NY
Year:	2009
Other	
Approval Date	
Feb 16 2010	

Instructor: Bob Abele
One/two sections offered each semester

PHILO-130 Critical Thinking: Reasoning in Everyday Life

This course introduces students to the principles of inductive and deductive inference and their practical applications in everyday situations such as problem solving and evaluation of arguments. The course examines the uses of language, formal and informal fallacies, syllogistic argument forms and scientific method. This course also develops the ability to integrate the principles of critical thinking with the techniques of effective written argument.

PHILO-141 Introduction to the Philosophy of Religion

This course is a general introduction to the nature of religion. Students will analyze central themes (such as revelation, faith, and miracles) and issues (such as the problem of evil, and the relationship between religion and science).

PHILO-220 Comparative Religion

The religious thought, experience, and ethical teachings of living religions of the world are examined, discussed and compared. Religions, which may be discussed, include Hinduism, Jainism, Buddhism, Sikhism, Zoroastrianism, Judaism, Christianity, and Islam.

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UNIVERSITY OF CALIFORNIA, LOS ANGELES

Dominic Franzella

Subject: FW: ECC Meeting
Attachments: Ethics Curricula UCLA.doc

From: Freixes, Gonzalo [redacted]
Sent: Wednesday, December 08, 2010 10:25 AM
To: Dominic Franzella
Subject: RE: ECC Meeting

Hi Dominic and Cindi,

As requested, attached is a summary of courses at UCLA that have Ethics specifically imbedded in its curriculum as a primary focus. I hope this information is helpful as you compile data for our next meeting. If you need anything further, please let me know.

For you information, I am flying back from Miami the morning of January 26th to make our meeting in Irvine. I expect to be there on time absent flight delays (but you know how that is).

Gonzalo

--
Gonzalo Freixes
Associate Dean
Professional MBA Programs
and Global Immersion Programs
UCLA Anderson School of Management
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BUSINESS BEYOND USUAL 75 YEARS
UCLA Anderson
School of Management

Ethics Course Curricula at UCLA

The UCLA undergraduate catalog focuses the study of ethics into the Political Science, Public Policy, and Philosophy departments, with one course specializing in this area in the Management (Accounting) and Communications Department. These courses generally provide a setting for the study of both the theoretical framework of ethics and the history of the development of cultural ethical theory in the context of the historical/social focus of the study provided by each of these departments. The Department of Philosophy bases study more closely on the development of ethical theory and ethical writings, while the other departments focus on the practice and resulting institutions.

Philosophy Department

The Department of Philosophy presents an extensive study of ethics and the history of ethical thought, distributing courses on the subject matter in both lower and upper division courses to the extent of devoting an entire upper-division course block to the study of ethics (Courses 150-166).

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2. Introduction to Philosophy of Religion. (4)
Lecture, three hours; discussion, one hour. Introductory study of such topics as nature and grounds of religious belief, relation between religion and ethics, nature and existence of God, problem of evil, and what can be learned from religious experience.

22. Introduction to Ethical Theory. (5)
Lecture, three hours; discussion, one hour. Not open for credit to students with credit for course 22W. Recommended or required for many upper division courses in Group III. Systematic introduction to ethical theory, including discussion of egoism, utilitarianism, justice, responsibility, meaning of ethical terms, relativism, etc. P/NP or letter grading.

22W. Introduction to Ethical Theory. (5)
Lecture, three hours; discussion, one hour. Enforced requisite: English Composition 3 or 3H or English as a Second Language 36. Limited to freshmen/sophomores. Not open for credit to students with credit for course 22. Introduction to major ethical theories in Western thought. Examination of works of Plato, Aristotle, Hume, Kant, and Mill. Topics include ideas of virtue, obligation, egoism, relativism, and foundations of morals. Four papers required. Satisfies Writing II requirement. Letter grading.

C114. Hume. (4)
Lecture, four hours. Preparation: one philosophy course. Selected topics from metaphysical, epistemological, and ethical writings of Hume. Limited to 40 students when concurrently scheduled with course C214. P/NP or letter grading.

C115. Kant. (4)
(Formerly numbered 115.) Lecture, three hours; discussion, one hour. Requisite: course 21 or 22. Study of Kant's views on related topics in theory of knowledge, ethics, and politics. May be repeated for credit with consent of instructor. Concurrently scheduled with course C215. P/NP or letter grading.

150. Society and Morals. (4)
Lecture, three hours; discussion, one hour. Requisite: course 22. Critical study of principles and arguments advanced in discussion of current moral and social issues. Topics similar to those in course 4, but familiarity with some basic philosophical concepts and methods presupposed. May be repeated for credit with consent of instructor.

151A-C151B-151C. History of Ethics. (4-4-4)
Lecture, three hours; discussion, one hour. Preparation: two philosophy courses. Each course may be taken independently for credit. P/NP or letter grading. 151A. Selected Classics in Ancient Ethical Theories: Plato, Aristotle; C151B. Modern. Intensive study of Kant's ethical theory. May be repeated for credit with consent of instructor. May be concurrently scheduled with course C245; 151C. Selected Classics of Medieval Ethics.

153A. Topics in Ethical Theory: Normative Ethics. (4)
Lecture, three hours; discussion, one hour. Requisite: course 22. Study of selected topics in normative ethical theory. Topics may include human rights, virtues and vices, principles of culpability and praiseworthiness (criteria of right action). May be repeated for credit with consent of instructor. P/NP or letter grading.

C153B. Topics in Ethical Theory: Metaethics. (4)
Lecture, three hours; discussion, one hour. Requisite: course 22. Study and analysis of basic concepts, selected problems, and contemporary issues in metaethics. Topics may include analysis of moral language, justification of moral beliefs, moral realism, skepticism, free will, moral motivation, etc. May be repeated for credit with consent of instructor. May be concurrently scheduled with course C253B. P/NP or letter grading.

154. Topics in Value Theory: Rationality and Action. (4)
Lecture, three hours; discussion, one hour. Requisite: course 6 or 7 or 22. Selected topics concerning normative issues in practical rationality or philosophy of action. Topics may include moral and practical dilemmas, nature of reasons for action, rationality of morality and prudence, weakness of will, freedom of will, and decision theory. May be repeated for credit with consent of instructor. P/NP or letter grading.

154B. Topics in Value Theory: Moral Responsibility and Free Will. (4)
Lecture, three hours; discussion, one hour. Preparation: one philosophy course. Examination of philosophical problems surrounding moral responsibility and free will, using contemporary or classical readings in attempt to better understand kind of freedom required for moral agents. P/NP or letter grading.

155. Medical Ethics. (4)
Lecture, three hours; discussion, one hour. Examination of philosophical issues raised by problems of medical ethics, such as abortion, euthanasia, and medical experimentation. P/NP or letter grading.

C156. Topics in Political Philosophy. (4)
Lecture, three hours; discussion, one hour. Analysis of some basic concepts in political theory. May be repeated for credit with consent of instructor. May be concurrently scheduled with course C247. P/NP or letter grading.

157A-157B. History of Political Philosophy. (4-4)
Lecture, three hours; discussion, one hour. Preparation: two philosophy courses. May be repeated with consent of instructor. 157A. Reading and discussion of classic works in earlier political theory, especially those by Hobbes, Locke, Hume, and Rousseau. 157B. Reading and discussion of classic works in later political theory, especially those by Kant, Hegel, and Marx.

161. Topics in Aesthetic Theory. (4)
Lecture, three hours; discussion, one hour. Preparation: one philosophy course. Philosophical theories about nature and importance of art and art criticism, aesthetic experience, and aesthetic values. May be repeated for credit with consent of instructor.

166. Philosophy of Law. (4)
Lecture, three hours; discussion, one hour. Preparation: one philosophy course. Examination, through study of recent philosophical writings, of such topics as nature of law, relationship of law and morals, legal reasoning, punishment, and obligation to obey the law. P/NP or letter grading.

Political Science Department

Ethics study in the Department of Political Science is limited primarily to the upper-division curriculum, dealing with ethical and moral questions of governance after meeting the lower-division requirements for political theory and governmental thought.

M115A. Ethics and Governance. (4)
(Formerly numbered 115A.) (Same as Human Complex Systems M145 and Public Policy M122.) Lecture, three or four hours; discussion, one hour (when scheduled). Designed for juniors/seniors. Study of applied ethics and governance, taking case-based approach, mixing normative and positive perspectives. Is action X morally right or wrong? How do people reason about whether action X is morally right or wrong? How do governance structures influence how people reason about whether action X is morally right or wrong? How can we design governance structures that encourage people to act ethically, contribute to public goods, and lead productive and fulfilled lives? May be applied toward Field I or III. P/NP or letter grading.

M115B. Political Ethics. (4)
(Same as Public Policy M126.) Lecture, three or four hours; discussion, one hour (when scheduled). Course M115A is not requisite to M115B. Designed for juniors/seniors. Study of major issues in morality, or lack thereof, of political life. Coverage of both readings in moral and political theory and real-world examples such as Watergate, terrorism, civil rights politics, and presidential campaigns. Topics include basic ethical theory, role-relative ethics, Machiavellian amoralism, democratic responsibility and representation, ethics of compromise, dirty hands problems, international ethics. Letter grading.

M115C. Citizenship and Public Service. (4)
(Formerly numbered 115C.) (Same as Civic Engagement M115.) Lecture, three or four hours; discussion, one hour (when scheduled). Recommended requisite: course 10. Designed for juniors/seniors. Study of ways in which political thinkers have conceived of ideas of citizenship and public service, how these ideas have changed over time, and frameworks for thinking about citizenship in era of markets and globalization. P/NP or letter grading.

M115D. Diversity, Disagreement, and Democracy: Can’t We All Just Get Along? (4)
(Same as Human Complex Systems M140D.) Lecture, three or four hours; discussion, one hour (when scheduled). Designed for juniors/seniors. Can’t we all just get along? Study of diversity, disagreement, and democracy. Diversity covers individual differences, cultural differences, and

human universals; groupism, factionalism, and identity politics; multiculturalism and one-world ethics. Disagreement includes moral, ideological, and party-political disagreement; resolvable and irresolvable kinds of disagreement; groupthink and group polarization; herding and information cascades. Democracy stands for political mechanisms of information aggregation; political mechanisms to resolve differences, or to keep peace among people with irresolvable differences; emergence and spread of democracy, liberty, and rule of law. Letter grading.

M120C. U.S. Intelligence Agencies in Theory and Practice. (4)
(Same as Public Policy M118.) Lecture, three hours; discussion, one hour. Limited to juniors/seniors. Examination of U.S. intelligence agencies from Cold War to present. Particularly in light of 9/11 and Iraq war, few organizations are more important and less understood. Course separates fact from fiction, comparing how intelligence agencies are portrayed in popular entertainment to how they operate in practice. Fundamentals of intelligence collection (from satellites to spies) and analytic tradecraft; key challenges such as role of ethics in intelligence; performance of U.S. intelligence agencies during Cold War; and intelligence community's ability to adapt to rise of terrorism. Application of general concepts to specific case studies of Cuban missile crisis, 2003 Iraq war, and September 11, 2001, terrorist attacks. Letter grading.

M142D. Understanding Public Issue Life Cycle. (4)
(Formerly numbered 142D.) (Same as Public Policy M127.) Lecture, three or four hours; discussion, one hour (when scheduled). Recommended preparation: courses 10, 40, and one course from Economics 1, 2, 5, 11, 100, or 101. Examination of how public issue life cycle is shaped by (1) economic and political incentives of various actors—business, news media, mass public, organized interests, Congress, the president, regulatory agencies, and courts and (2) ideology, cognitive biases, and ethical reasoning. P/NP or letter grading.

146F. Politics, Ethics, and Business. (4)
Lecture, three or four hours; discussion, one hour (when scheduled). Requisite: course 40. Designed for juniors/seniors. Examination of political issues, interests, and institutions that impose constraints on and provide opportunities for business. Ethical issues that arise in external environment of business and its internal operations. Examples of topics include government regulation, product liability, affirmative action, lobbying Congress, exporting hazardous waste to developing countries. P/NP or letter grading.

Public Policy Department

Ethics courses in the Department of Public Policy focus on the study of ethical behavior in the public theatre and in management. Courses are often inter-departmental with the Department of

Political Science, and provide a background as to not only how but why public policy decisions are made.

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103. Ethics, Morality, and Public Life: Contemporary Controversies. (4)
Lecture, four hours; outside study, eight hours. Study of ethical and moral questions that arise in public life. Goal is not to imbue students with a given body of factual knowledge or to develop new quantitative or social science methodologies to analyze such questions, but to enhance their critical thinking skills. Letter grading.

M122. Ethics and Governance. (4)
(Same as Human Complex Systems M145 and Political Science M115A.) Lecture, three or four hours; discussion, one hour (when scheduled). Designed for juniors/seniors. Study of applied ethics and governance, taking case-based approach, mixing normative and positive perspectives. Is action X morally right or wrong? How do people reason about whether action X is morally right or wrong? How do governance structures influence how people reason about whether action X is morally right or wrong? How can we design governance structures that encourage people to act ethically, contribute to public goods, and lead productive and fulfilled lives? P/NP or letter grading.

M126. Political Ethics. (4)
(Formerly numbered CM126.) (Same as Political Science M115B.) Lecture, three or four hours; discussion, one hour (when scheduled). Designed for juniors/seniors. Study of major issues in morality, or lack thereof, of political life. Coverage of both readings in moral and political theory and real-world examples such as Watergate, terrorism, civil rights politics, and presidential campaigns. Topics include basic ethical theory, role-relative ethics, Machiavellian amoralism, democratic responsibility and representation, ethics of compromise, dirty hands problems, international ethics. Letter grading.

148. Business and Public Policy. (4)
Lecture, three hours; outside study, nine hours. Requisite: course 10A. Introduction to key issues arising at interface between business and government policy. Discussion of why government focuses so intensively on regulating economic outcomes, nature of business/government relationship, business political activity, and major government policies. Topics include economic regulation (industrial policy, antitrust, technology policy); social regulation of business (energy, environment, risk, liability, corporate governance); and corporate social responsibility, business ethics, and green business. Discussion of topics in their historical and political context, with comparison between economic regulation in the U.S. and other countries. Letter grading.

209. Management in the 21st Century. (4)
Lecture, three hours; outside study, nine hours. Overview of moral philosophy, political theory, and public-sector ethics using readings from classical and contemporary literature and case studies. Consideration of various ways in which terms such as “democracy” and “liberty” are used in public discourse. Practice in developing and defending moral arguments, both orally and in writing. Letter grading.

237. Ethical Questions in Public Life. (4)
Lecture, three hours; outside study, nine hours. Introduction to moral issues that commonly arise in public life. Ethics of political roles, compromise and moral integrity, lying and deception, place of rhetoric in defending stand on issues, politics and violence. Letter grading.

Management (Accounting) Department

Management 180: Law & Ethics. This course focuses on advanced legal & ethical topics for the businessperson or entrepreneur, including an overview of strategies in business entity selection, corporate governance and financing, securities regulation, international business transactions and employment law. The class specifically focuses on ethical considerations that businesses, corporate executives and investment professionals must take into account in the financing and operation of corporations or other public business entities.

Communications Department

Communication Studies 187: Ethical and Policy Issues in Institutions of Mass Communication. Intensive examination of ethical and policy issues arising from interaction of media institutions (print, film, broadcasting, and new technologies) and societal institutions (Congress, federal agencies, courts, the Presidency, schools, churches, political action groups, advertisers, and audiences.)

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UNIVERSITY OF SAN DIEGO

THE USD ADVANTAGE

At the University of San Diego, we are committed to academic excellence as well as an ethics-based curriculum

http://www.sandiego.edu/business/documents/MACC.pdf

MASTER OF SCIENCE IN ACCOUNTANCY "MACC"

THE MISSION OF THE USD ACCOUNTANCY PROGRAMS IS TO DEVELOP ACCOUNTANTS # THROUGH THE USE OF PERSONALIZED, INNOVATIVE TEACHING METHODS DEVELOPED BY FACULTY WHO ARE ACTIVE IN THE PRODUCTION AND DISSEMINATION OF KNOWLEDGE & WHO HAVE THE SKILLS TO COMPETE IN A DIVERSE AND FAST CHANGING GLOBAL PROFESSIONAL ENVIRONMENT

MACC 501
Communications and Ethics for Financial Professionals / 3 units
This course will focus on improving business presentation skills with several oral presentations required during the course. The course will also introduce basic behavioral or communication skills needed to manage yourself and relationships with others in organizations. Skills learned will include self-management, goal setting, strategic thinking, communicating, creative problem solving, resolving conflicts, team building, motivating, leading change, and evaluating performance. The development of professional ethics and values will be stressed and will comprise a minimum of one-third of the material in this course. Prerequisite: Admission to the B.A.C.C./ M.A.C.C. or M.T.A.X. programs or either of the M.A.C.C. or M.T.A.X. combined programs.

MACC 502
Leadership in a Financial Team Environment / 3 units
This course examines the challenges of creating and leading in a team-based organizational culture. Topics include stages of team development, leadership style, team chartering, conflict management, decision-making, process facilitation, leadership interventions, and team member skills. Teaching methods include assessments, role-plays, case studies, simulations, skill practice, and a project documenting a team leadership experience. Discussion of the interaction of professional ethics and team leader behavior will comprise a minimum of one-third of this course. Prerequisite: Admission to the M.A.C.C. or M.T.A.X. programs or B.A.C.C./ M.A.C.C. or M.T.A.X. combined programs.

MACC 503
Negotiations: Strategy, Practice, and Ethics / 3 units
This course is designed to raise your negotiation competency by presenting a comprehensive, logical approach to a wide variety of negotiation situations. Based on experiential learning, the course will use live negotiation situations where students can develop strategies, employ bargaining tactics, and structure agreements. In addition, the course will examine how to integrate the strategic goals of an organization with the strategic goals of your negotiations and to use negotiations to create value. The course will allow students to examine areas of strength and weakness in their own negotiating style. Finally, negotiating strategy and tactics are set in

the context of a code of personal and professional ethical conduct with a minimum of one-third of the course devoted to understanding how ethical issues should impact the negotiation process. Prerequisite: Admission to the M.A.C.C. or M.T.A.X... programs or either of the B.A.C.C./ M.A.C.C. or M.T.A.X. combined programs.

MACC 540
Controllership and Cost Management / 3 units
This course will focus on current controllership and strategic cost management topics. Topics to be studied include activity based costing, balanced scorecard, benchmarking, and management control systems. Teaching methods include lecture or discussions, case studies, and presentations. Development of appropriate values and ethics needed by company controllers is included in the course. Prerequisites: ACCT 302 or GSBA 510 and 511.
MACC 560
Tax Research / 3 units
This course examines research methods used for Federal taxation. Topics include ethics, tax research methodology, primary sources of law, secondary sources of law, and tax practice. Students will use electronic databases and other library resources to research fact patterns in groups and present their findings to the class. In addition, students are expected to do the necessary background reading and take related tests on the topics studied. Prerequisites: ACCT 306.

MACC 561
Partnership Taxation / 3 units
This course examines tax reporting for non-corporate entities including partnerships, limited liability companies (LLCs), and limited liability partnerships (LLPs), and the taxation of entity owners. Students who complete this course will: (1) understand common partnership, LLC, and LLP terminology, (2) know how and where to research non-corporate tax issues, / 3 units learn to prepare and review common non-corporate entity tax reports, (4) develop skills in communicating tax issues and answers to clients, (5) understand non-corporate tax planning techniques, (6) understand how to creatively structure transactions consistent with current tax laws, and (7) understand how the California Board of Accountancy Ethics requirements apply to taxation issues. Problem based learning (practice problems, cases, and examples) will provide the core methods of classroom instruction. Prerequisites: ACCT 407.

- USD maintains a database of Ethics Case studies.
  http://ethics.sandiego.edu/resources/cases/HomeOverview.aspcul

- Six professors teach ethics at School of Business:
  Craig Barkacs
  Linda Barkacs
  Marc Lampe
  Gary Whitney
  Two adjuncts

- USD offers a set of ethics-based classes under the ETLW (Ethics & the Law) offered to Accountancy majors. These include : Business & Society, Business Law I and Business Law II.
  http://www.sandiego.edu/business/programs/undergraduate/bachelor_accountancy/accountancy_curriculum.php
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Accountancy Curriculum

UPPER DIVISION CURRICULUM BUSINESS COMPONENT

MGMT 300 Organizational Behavior
FINA 300 Financial Management
MKTG 300 Fundamentals of Marketing
ETLW 302 Business and Society
ETLW 311 Business Law I
DSCI 300 Management Science
DSCI 303 Operations Management
MGMT 490 Strategic Management
ACCOUNTANCY COMPONENT (24 or 27 units)
Students must complete the requirements of one of the following Accountancy Component options:
Option 1: Accountancy Option (24 units)
This option provides a primary emphasis in accountancy that is recommended for students who desire careers in public accounting and who plan on taking the Certified Public Accountant (CPA) Examination. This option is also recommended for students interested in industry related accounting careers where the Certificate in Management Accounting (CMA) is desirable.
ACCT 300 Intermediate Accounting I
ACCT 301 Intermediate Accounting II
ACCT 302 Cost Accounting
ACCT 303 Accounting Information Systems
ACCT 306 Federal Tax Accounting I
ACCT 401 Advanced Accounting
ACCT 408 Auditing
One of the following Accounting Elective Courses:
ACCT 407 Federal Tax Accounting II
ETLW 312 Business Law II
(48-51 units)

- Ranked by Business Week as #13 in teaching business ethics

http://www.sandiego.edu/business/about/rankings.php

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MEMO FROM
MR. MICHAEL UELTZEN, CPA

UELTZEN & COMPANY, LLP
CERTIFIED PUBLIC ACCOUNTANTS

MEMORANDUM

Date: December 6, 2010

To: Don Driftmier
Chair, Accounting Ethics Committee
California Board of Accountancy

From: Michael G. Ueltzen, Committee Member

RE: Practitioner Observations – 10-unit Ethics Requirement

Committee Members at our last meeting requested that I provide insight from the viewpoint of the practicing CPA as to the implications of the 10 unit Ethics Requirement.

I have attached two studies that I think are relevant to ethics and ethics violations in the practice of public accountancy. As you may be aware, much of my practice focuses on forensic accounting and, accordingly, I become involved in many of the fraud claims and financial statement frauds.

One of the fundamental questions the Committee should address is whether:

1. The 10-unit ethics requirement is to be targeted to improve and enhance the ethics of the CPA, or
2. Is the 10-unit Ethics Requirement intended to assist the practicing CPA to assess the CPA's clients' ethics?

That issue has not been well defined for me nor has any clarification been provided me as to whether the purpose of increased ethics education is to detect and deter fraud. If the intent is to detect and deter fraud, it would be my observation that increased ethics requirements will not solve the problem. If, on the other hand, the intent is to become the "client ethics cops," then this represents a service that is not anticipated in any audit. Much of the professional focus in recent years has appropriately been on fraud detection and fraud deterrence.

I have attached two studies that I believe have bearing on the issue of fraud and fraud deterrence, both of which are fairly well known:

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- *Deterring and Detecting Financial Reporting Fraud*, *A Platform for Action* published by the Center for Audit Quality; and,
- The Committee of Sponsoring Organizations of the Treadway Commission ("COSO") *Fraudulent Financial Reporting 1998 through 2007 – An Analysis of U.S. Public Companies*.

The Center for Audit Quality publication identifies three key elements for Deterring and Detecting Fraud:

1. Ethical tone at the top,
2. Professional skepticism, and
3. Open communication.

The analysis performed by the Committee of Sponsoring Organizations primarily focused on two areas relevant to our charge:

1. Revenue recognition constituted the primary area of financial statement fraud and
2. There were few differences in the Board of Director characteristics with those entities that experienced a financial statement fraud and those that did not.

I reviewed each of these studies and it does not appear that the issue of CPAs and their ethical stature in the business world is a core issue in either of the studies.

MGU:jer
Enclosures

DETERRING and DETECTING FINANCIAL REPORTING FRAUD

A Platform for Action

October 2010

CENTER FOR AUDIT QUALITY

Serving Investors, Public Company Auditors & the Markets

Affiliated with the American Institute of CPAs

THE CENTER FOR AUDIT QUALITY AND ITS VISION

The Center for Audit Quality (CAQ) is dedicated to enhancing investor confidence and public trust in the global capital markets by:

- Fostering high-quality performance by public company auditors
- Convening and collaborating with other stakeholders to advance the discussion of critical issues requiring action and intervention
- Advocating policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions

The CAQ is an autonomous public policy organization based in Washington, D.C. It is governed by a board comprised of leaders from the public company audit firms, the American Institute of Certified Public Accountants (AICPA), and three individuals independent of the profession. The organization is affiliated with the AICPA.

ABOUT THIS REPORT

This report focuses on financial reporting fraud at publicly-traded companies of all sizes, and its recommendations are intended to be scalable to different situations. While the report addresses specific structures, such as an internal audit function or a formal fraud risk management program, it is not intended to suggest that one size fits all, or to be limited to any single implementation approach. It is important that each company consider the concepts presented and tailor them to its particular characteristics. While not the specific focus of this report, many of the points may be applicable to other types of organizations, such as privately-owned companies, not-for-profit organizations, and governmental entities.

ACKNOWLEDGEMENTS

We would like to thank all those who participated in the discussions and interviews, and the drafting of this document; this report would not have been possible without you. We appreciate the wisdom shared throughout this process. While there are too many who contributed to name, we would like to mention one — Elizabeth Rader, director at Deloitte LLP — for her immense contribution in reviewing the material and drafting this report.

On behalf of the Center for Audit Quality (CAQ), we are pleased to present this report on *Deterring and Detecting Financial Reporting Fraud—A Platform for Action.* Financial reporting fraud—defined for this report as "a material misrepresentation resulting from an intentional failure to report financial information in accordance with generally accepted accounting principles"—is a serious concern for investors and other capital market stakeholders. There is no way to predict who will commit fraud. Moreover, because fraud is intentionally concealed by the perpetrators, it often is difficult to detect for some time. Multiple cases of financial reporting fraud have undermined confidence in the U.S. capital markets in the past few decades.

The CAQ is committed to enhancing investor confidence and public trust in the capital markets. We advocate policies and standards that foster the highest-quality performance by public company auditors, and we act as a convener and collaborator with other stakeholders to foster informed discussions on issues pertaining to the integrity of financial reporting.

During 2009 and early 2010, the CAQ sponsored a series of discussions and in-depth interviews to obtain perspectives on fraud deterrence and detection measures that have worked, and on ideas for new approaches. The participants included the full spectrum of stakeholders with an interest in the integrity of financial reports of publicly-traded companies: corporate executives, members of boards of directors and audit committees, internal auditors, external auditors, investors, regulators, academics, and others.

This report is the result of those discussions and interviews, considered in light of related research and guidance on the topic. The report contains numerous ideas for mitigating the risk of financial reporting fraud, as well as points to ponder. Notably, discussion participants strongly believe that ongoing collaboration and the collective sharing of ideas and resources would greatly advance efforts to mitigate financial reporting fraud.

Accordingly, this report represents a first step in longer-term initiatives and collaborations for the deterrence and detection of financial reporting fraud, to benefit investors and other participants in the capital markets. The CAQ plans to play a leadership role in encouraging collaborative action to advance the understanding of conditions that contribute to fraud and develop enhanced deterrence and detection techniques and tools for all participants in the financial reporting process, including management, boards of directors, audit committees, internal auditors, and external auditors. We intend these efforts to complement the activities of the Public Company Accounting Oversight Board's (PCAOB) Financial Reporting Fraud Resource Center, and look forward to opportunities for collaboration with the Center.

We are delighted to announce that Financial Executives International, The Institute of Internal Auditors, and the National Association of Corporate Directors, organizations that already are actively engaged in efforts to mitigate the risk of financial reporting fraud, plan to collaborate with the CAQ on these initiatives.

We hope this report provides food for thought and spurs stakeholders to leverage our resources to advance the deterrence and detection of financial reporting fraud. We look forward to working with all interested parties in the future.

Michele J. Hooper
Co-Vice Chair, Governing Board
Center for Audit Quality

Cynthia M. Fornelli
Executive Director
Center for Audit Quality

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Executive Summary

On a number of occasions over the past few decades, major public companies have experienced financial reporting fraud, resulting in turmoil in the U.S. capital markets, a loss of shareholder value, and, in some cases, the bankruptcy of the company itself. The Sarbanes-Oxley Act of 2002 has done much to improve corporate governance and deter fraud; however, financial reporting fraud—an intentional, material misrepresentation of a company's financial statements—remains a serious concern for investors and other capital markets stakeholders.

In 2009, the Center for Audit Quality (CAQ), which is committed to enhancing investor confidence and public trust in the capital markets, convened five roundtable discussions (four in the United States, one in London) with more than 100 participants, followed by more than 20 in-depth interviews, in order to capture perspectives on fraud deterrence and detection measures that have worked and ideas for new approaches. The participants included corporate executives, members of boards of directors and audit committees, internal auditors, external auditors, investors, regulators, academics, and others.

The observations in this report are derived from those discussions and interviews, considered in light of related research and guidance on the topic. The report contains ideas for mitigating the risk of financial reporting fraud, as well as related points to ponder. It represents a first step in advancing longer-term initiatives and collaborations for the deterrence and detection of financial reporting fraud, to benefit investors and other participants in the capital markets.

Understanding the Landscape

The Fraud Triangle. Theoretically, anyone has the potential to engage in financial reporting fraud; indeed, some individuals who commit fraud had previous reputations for high integrity. Three factors, referred to as the "fraud triangle," often combine to lead individuals to commit fraud: pressure or an incentive to engage in fraud; a perceived opportunity; and the ability to rationalize fraudulent behavior.

Participants in the CAQ discussions identified the top three pressures for fraud as personal gain (including maximizing performance bonuses and stock-based compensation); the need to meet short-term financial expectations; and a desire to hide bad news. Opportunities for fraud usually are greatest when the tone at the top is lax or controls are ineffective, although even the best controls cannot completely eliminate the risk of fraud. Finally, individuals who commit financial reporting fraud must be able to justify or explain away their fraudulent actions.

Typically, financial misstatement or manipulation starts small, intended as "just a little adjustment" to improve results. But as the need to maintain the deception continues, one misstatement leads to another until the perpetrator is locked in, loses objectivity, and heads down the "slippery slope" to commit major fraud.

Historically, most major financial statement frauds have involved senior management, who are in a unique position to perpetrate fraud by overriding controls and acting in collusion with other employees. When fraud occurs at lower levels in an organization, individuals may not initially realize that they are committing fraud; they may see themselves as simply doing what is expected to "make their numbers."

The Financial Reporting Supply Chain. Management, boards of directors, audit committees, internal auditors, and external auditors make up the public company financial reporting process or "supply chain" and have complementary and interconnected roles in delivering high-quality financial reporting to the investing public, including the deterrence and detection of fraud.

Management has primary responsibility for the financial reporting process and for implementing controls to deter and detect financial reporting fraud. Boards of directors and audit committees are responsible for oversight of the business and the control environment. The audit committee oversees the financial reporting process, the internal audit function, and the company's external auditors.

Internal auditors play a key role in a company's internal control structure and have a professional responsibility to evaluate the potential for the occurrence of fraud and how the organization manages fraud risk. External auditors must be independent of the company they audit and provide a public report on the entity's annual financial statements, including—for U.S. public companies with $75 million or more in market capitalization—an opinion on the effectiveness of the entity's internal control over financial reporting.

Fraud Deterrence and Detection

How can those in the financial reporting supply chain individually and collaboratively mitigate the risk of financial reporting fraud? While there is no "silver bullet," the CAQ discussion participants consistently identified three themes:

- A strong, highly ethical tone at the top that permeates the corporate culture (an effective fraud risk management program is a key component of the tone at the top)
- Skepticism, a questioning mindset that strengthens professional objectivity, on the part of all participants in the financial reporting supply chain
- Strong communication among supply chain participants

Tone at the top. A strong ethical culture starts at the top with a company's most senior leaders and cascades through the entire organization to create, in the words of a CAQ discussion participant, a "mood in the middle" and a "buzz at the bottom" that reflect and reinforce the tone at the top.

Corporate culture influences all three sides of the fraud triangle. A strong ethical culture creates an expectation to "do the right thing" and counteracts pressure and incentives to commit fraud. An ethical culture also supports well-designed, effective controls that diminish opportunities for fraud and increase the likelihood that fraud will be detected quickly. In addition, a culture of honesty and integrity severely limits an individual's ability to rationalize fraudulent actions.

CAQ discussion participants agreed that management plays the most critical role in building a strong ethical culture. They emphasized that, to do so, senior management must clearly communicate ethical expectations and visibly live by them. Importantly, employees need to hear the same messages from their immediate supervisors, because they have the most powerful and direct influence on the ethical judgments of their employees.

Tone at the top is reinforced through the establishment of a comprehensive fraud risk management program with a readily accessible confidential whistleblower program. In fact, studies show that fraud most often is detected through tips. In multinational organizations, it is critical that ethics and fraud deterrence programs also account for cultural differences.

Boards and audit committees support and reinforce the tone at the top in part by choosing the right management team. Audit committees oversee the financial reporting process, including monitoring fraud risk and the risk of management override of controls. Boards, through the compensation and audit committees, also reinforce the company's ethical values by reviewing compensation plans, especially those for senior management, for unintentional incentives to commit financial reporting fraud.

The internal audit function tests and monitors the design and effectiveness of fraud programs and internal control over financial reporting. According to The Institute of Internal Auditors (The IIA), internal audit should operate with organizational independence, which commonly includes direct reporting to the audit committee and unrestricted access to the board and audit committee should matters of concern arise. External auditors have the responsibility to plan and perform an audit to obtain reasonable assurance that the financial statements are free of material misstatement, whether caused by error or fraud.

Skepticism. Skepticism involves the validation of information through probing questions, the critical assessment of evidence, and attention to inconsistencies. Skepticism is not an end in itself and is not meant to encourage a hostile atmosphere or micro-management; it is an essential element of the professional objectivity required of all participants in the financial reporting supply chain. Skepticism throughout the supply chain increases not only the *likelihood* that fraud will be detected, but also the *perception* that fraud will be detected, which reduces the risk that fraud will be attempted.

CAQ discussion participants noted that management exercises skepticism by periodically testing assumptions about financial reporting processes and controls, and remaining cognizant of the potential for fraud, particularly if the organization is under financial pressure. They emphasized the importance of having boards and audit committees employ a skeptical approach in discharging their oversight responsibilities. To exercise skepticism effectively, board and audit committee members need a thorough knowledge of the company's business (especially the drivers of its revenue and profitability), its industry and competitive environment, and key risks.

For both internal and external auditors, skepticism is an integral part of the conduct of their professional duties, including the consideration of the risk of management override of controls. Internal and external auditors can also provide insight into the company's ethical culture and the effectiveness of its internal controls to assist board and audit committee members in exercising skepticism.

Communication Across the Financial Reporting Supply Chain. Participants in the CAQ discussions stressed that financial reporting supply chain participants should leverage their complementary and interconnected responsibilities through frequent and robust communications to share insights and eliminate gaps in their collective efforts.

The audit committee is a hub for many of these communications because it has direct reporting lines from management, the internal auditor, and the external auditor. In addition to regular communications with these groups, executive sessions with each of them, as well as with selected key employees, can be a valuable tool for boards and audit committees to obtain a broad perspective on the company's financial reporting environment. Also, regular communication among management, the internal auditor, and the external auditor is integral to the accomplishment of each party's responsibilities.

Together, these communications enable the sharing of information, perspectives, and concerns that provide a view into the company that is "greater than the sum of its parts." Open and robust exchanges that consciously strive to avoid minimalist, compliance-oriented discussions will yield maximum benefits for all parties.

The Case for Collaboration: Increasing Effectiveness Across the Financial Reporting Supply Chain

CAQ discussion participants agreed that while supply chain participants work to deter and detect financial reporting fraud one company at a time, the collective sharing of ideas and resources would greatly advance efforts to mitigate financial reporting fraud.

The CAQ believes that such collaboration would indeed enhance the ability of participants in the financial reporting supply chain to deter and detect financial reporting fraud and thereby sustain and enhance confidence in the capital markets over the long term. In addition to the discussion participants, the CAQ sought input on this report from Financial Executives International (FEI), the National Association of Corporate Directors (NACD), and The IIA, organizations that already are actively engaged in efforts to mitigate the risk of financial reporting fraud. Each of these organizations provided significant support and insights, and expressed interest in further collaboration.

In light of the positive reception this effort has received and the importance of this issue to investor confidence, the CAQ plans to play a leadership role by encouraging continued collaboration with these key stakeholders (and other professional organizations where appropriate) to leverage existing resources, share ideas, and prioritize future activities to advance the deterrence and detection of financial reporting fraud. We will focus our initial efforts in four areas:

- Advance the understanding of conditions that contribute to fraud
- Promote additional efforts to increase skepticism
- Moderate the risks of focusing only on short-term results
- Explore the role of information technology in facilitating the deterrence and detection of fraudulent financial reporting

These areas represent the beginning of a focused and coordinated effort to mitigate the risk of financial reporting fraud and the damage it can cause to individual companies and the capital markets.


405,468
100,610
(41,033)
5,751
(1,252)

Financial Reporting Fraud

What It Is and Why the Center for Audit Quality Cares

Over the past few decades, multiple headline-grabbing cases of financial reporting fraud at public companies have rocked the capital markets. These frauds have a negative impact on the capital markets and erode the trust of the investing public. Financial reporting fraud can also have a devastating impact on a company's reputation, to the point of jeopardizing its existence.

The Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act" or "the Act") was enacted in response to the corporate scandals of the late 1990s and early 2000s, which resulted in major losses for investors and a precipitous decline in investor confidence in the U.S. capital markets. The requirements of the Sarbanes-Oxley Act were intended to strengthen public companies' internal controls over financial reporting and have served to sharpen the focus of senior management, boards of directors, audit committees, internal audit departments, and external auditors on their responsibilities for reliable financial reporting. Although it is generally accepted that the Sarbanes-Oxley Act has improved corporate governance and decreased the incidence of fraud, recent studies and surveys indicate that investors and management continue to have concerns about financial statement fraud. For example:

- The Association of Certified Fraud Examiners' (ACFE) *2010 Report to the Nations on Occupational Fraud and Abuse* found that financial statement fraud, while representing less than five percent of the cases of fraud in its report, was by far the most costly, with a median loss of $1.7 million per incident.
- *Fraudulent Financial Reporting: 1998–2007* from the Committee of Sponsoring Organizations of the Treadway Commission (the *2010 COSO Fraud Report*), analyzed 347 frauds investigated by the U.S. Securities and Exchange Commission (SEC) from 1998 to 2007 and found that the median dollar amount of each instance of fraud had increased three times from the level in a similar 1999 study, from a median of $4.1 million in the 1999 study to $12 million. In addition, the median size of the company involved in fraudulent financial reporting increased approximately six-fold, from $16 million to $93 million in total assets and from $13 million to $72 million in revenues.
- A 2009 KPMG survey of 204 executives of U.S. companies with annual revenues of $250 million or more found that 65 percent of the respondents considered fraud to be a significant risk to their organizations in the next year, and more than one-third of those identified financial reporting fraud as one of the highest risks.[1]
- Fifty-six percent of the approximately 2,100 business professionals surveyed during a Deloitte Forensic Center webcast about reducing fraud risk predicted that more financial statement fraud would be uncovered in 2010 and 2011 as compared to the previous three years. Almost half of those surveyed (46 percent) pointed to the recession as the reason for this increase.[2]

Because fraud can have such a devastating impact, the CAQ, consistent with its mission, convened five roundtable discussions in 2009. Representatives of all stakeholders affected by fraud were able to share perspectives, experiences, successful anti-fraud measures, and ideas for new approaches. The participants in these discussions included, among others, corporate executives, members of boards of directors and audit committees, internal auditors, external auditors, fraud specialists, investors, regulators, and academics. In order to facilitate a free flow of ideas, the roundtable discussions were conducted with no public attribution of comments to individual participants. These discussions were followed in early 2010 by in-depth interviews with more than 20 of the roundtable participants conducted by an independent research firm. The interviews delved further into the insights and observations of individual participants in the discussion groups, and participants agreed to be quoted in this report. The discussions and interviews focused on a particular subset of frauds, those that are material and involve a public company's financial reports. Other types of fraud, such as the misappropriation of assets, were outside the scope of the discussions.

The observations and areas of focus in this report are derived from these discussions and interviews. Throughout this report, where observations indicate that participants agreed on a particular point, it is meant to indicate general consensus, not necessarily that there was unanimity. The insights from the discussions were considered in light of related research, and they include both specific ideas for consideration by individual stakeholder groups, as well as several longer-term proposals for collaboration among all stakeholders. Together, these proposals represent the beginning of a long-term effort to advance the deterrence and detection of financial reporting fraud, with the ultimate goal of benefiting investors, other users of financial reports, and participants in the capital markets. This report and the ideas generated from it are intended to serve as a springboard for ongoing collaboration among all stakeholders to diminish the risk of financial reporting fraud.

The Sarbanes-Oxley Act—Legislation for Strong Governance and Accountability

The Sarbanes-Oxley Act of 2002 was enacted in response to the corporate scandals of the late 1990s and early 2000s. The Act mandated significant reforms to public companies' governance structures and the oversight of public company accounting firms. Many of its requirements were intended to raise the standard of corporate governance and mitigate the risk of fraudulent financial reporting. In particular, the Act:

- Reinforces the responsibility of corporate officers for the accuracy and completeness of corporate financial reports, and adds a requirement for the public certification of each periodic report filed with the SEC that includes financial statements. The chief executive officer and chief financial officer must certify that each such periodic report complies with the requirements of the Securities Exchange Act of 1934 and that the financial statements are fairly presented
- Establishes criminal penalties for a willful and knowing untrue certification
- Provides for the disgorgement of the bonuses and profits of executives involved in fraudulent financial reporting
- Requires evaluations and increased disclosures of a company's internal control over financial reporting by management, and a related report by the external auditor for certain companies
- Requires other enhanced disclosures, including whether the company has a code of ethics for senior financial officers
- Enhances the role of the audit committee, including requirements for financial expertise and responsibility for oversight of the company's external auditor
- Requires companies to establish whistleblower programs, and makes retaliation against whistleblowers unlawful

These provisions are generally held to have helped reduce financial reporting fraud and to serve as an ongoing deterrent to such fraud. Several CAQ discussion participants emphasized the deterrent effect of the criminal penalties for untrue certifications by the CEO or CFO.

CHAPTER 1

Understanding the Landscape

Why Commit Fraud—The Seductive Triangle

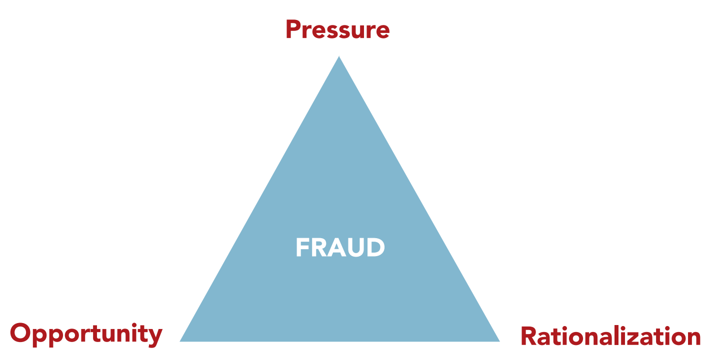
Three conditions typically are present when individuals commit fraud: pressure or an incentive to engage in fraud, a perceived opportunity, and the ability to rationalize fraudulent behavior. This "fraud triangle" was first developed by noted twentieth century criminologist Donald Cressey.[3] These three conditions may exist whether the economy is strong or weak, and, accordingly, fraud can be committed in both good times and bad. How then do these factors motivate fraud?

> There is a pressure at an individual level which I think is significantly associated with compensation arrangements in the organization. There is also pressure at a corporate level, when there is a negative economic environment that makes targets much harder to achieve. Both can create powerful incentives for financial statement fraud.
>
> **Ian Ball,** Chief Executive Officer, International Federation of Accountants

Pressure to commit fraud. Pressure can be either a positive or a negative force. When goals are achievable, pressure contributes to creativity, efficiency, and competitiveness. However, temptations for misconduct arise when goals do not appear to be attainable by normal means, yet pressure continues unabated, with career advancement, compensation, and even continued employment at risk. When pressure is transformed into an obsessive determination to achieve goals no matter what the cost, it becomes unbalanced and potentially destructive. That is when individuals are most likely to resort to questionable activities that may lead to fraud.

Participants in the CAQ roundtable discussions and interviews identified the top three motivators for fraud as *personal gain* (including maximizing performance bonuses and the value of stock-based compensation); *achieving short-term financial goals* (either internal targets or external analyst expectations); and *hiding bad news* from investors and the capital markets. Similarly, the *2010 COSO Fraud Report* found that the most commonly cited motivations for financial statement fraud were "the need to meet internal or external earnings ex-

The Fraud Triangle



pectations, an attempt to conceal the company's deteriorating financial condition, the need to increase the stock price, the need to bolster financial performance for pending equity or debt financing, or the desire to increase management compensation based on financial results." Interestingly, academic research indicates that the desire to recoup or avoid losses is much more likely to motivate an individual to engage in activities that could lead to fraud than the desire for personal gain.[4]

> **I think most people who come unstuck in this context of accounting misstatement are basically honest people who get caught up and then they get desperate.**
>
> **Jonathan Fisher QC,** Barrister, 23 Essex Street Chambers; Trustee, Fraud Advisory Panel

Other research has found that executives and mid-level managers feel that they face continual pressure to meet business objectives as well as the short-term financial goals of analysts and investors. In the KPMG 2008–2009 *Integrity Survey,* 59 percent of managers and employees acknowledged feeling pressure to do whatever it takes to meet business targets; 52 percent believed that they would be rewarded based on results rather than the means used to achieve them; and 49 percent feared losing their jobs if they missed their targets. Consistent with comments from multiple CAQ discussion participants, several recent academic studies have found that executives at companies accused of financial reporting fraud face greater financial incentives to increase stock price, in the form of stock or option holdings, than executives at companies where fraud was not found. The studies indicate that the motivation for fraud is often to increase or prevent a decrease in stock price.[5]

> **When we are talking about material financial statement fraud, it is likely that senior management either knows about it or has caused it by putting so much pressure on employees.**
>
> **Scott Taub,** Managing Director, Financial Reporting Advisors

Perceived Root Causes of Misconduct (a survey of 5,065 working adults)

Pressure to do "whatever it takes" to meet business targets	**59%**
Believe will be rewarded for results, not means	**52%**
Believe code of conduct not taken seriously	**51%**
Lack familiarity with standards for their jobs	**51%**
Lack resources to get job done without cutting corners	**50%**
Fear losing job if miss targets	**49%**
Believe policies easy to bypass or override	**47%**
Seek to bend rules for personal gain	**34%**

KPMG LLP (U.S.) *Integrity Survey 2008–2009*

Financial misstatement or manipulation often starts small, intended as "just a little adjustment" to meet earnings targets or give the company time to improve results. Initially, the individual involved may not even consider what is done to be unacceptable or fraudulent. But as the need to maintain the deception continues, one adjustment leads to another and the scope of the fraud expands until the perpetrator is locked in and headed down the "slippery slope" to major fraud.

Opportunity for fraud. Even when pressure is extreme, financial reporting fraud cannot occur unless an opportunity is present. Opportunity has two aspects: the inherent susceptibility of the company's accounting to manipulation, and the conditions within the company that may allow a fraud to occur. The nature of the company's business and accounting can provide sources of opportunity for fraud in the form of significant related-party transactions outside the ordinary course of business; a large volume of estimates of assets, liabilities, revenues, or expenses that are subjective or difficult to corroborate; and isolated, large transactions. Some large transactions, especially those close to period-end, can pose complex "substance over form" questions that provide opportunities for management to engage in fraudulent reporting.[6]

The opportunity for fraud is also affected by a company's internal environment, which is largely influenced by the entity's culture and the effectiveness of its internal controls. Strong controls can significantly limit possibilities for the manipulation of results or for fraudulent transactions. It is important to maintain a sharp focus on controls in both good and bad economic times. When results are strong and markets are up, there can be a tendency toward complacency, with diminished focus on internal controls and reduced scrutiny of results. In tough economic times, companies trying to do more with less may cut budgets in areas that compromise the effectiveness of internal controls. Both the

PricewaterhouseCoopers *2009 Global Economic Crime Study* and the Ernst & Young *2009 European Fraud Survey* indicated that staff reductions were likely to lead to inattention to normal financial control procedures and thus result in a greater risk of fraud.

> **The greatest risk of manipulation of financials is when management creates an impression that [the manipulation] is needed or expected . . . Most of the people committing fraud are not doing it for personal gain. They are doing it because they feel it is necessary and appropriate.**
>
> **Norman Marks,** Vice President, Governance, Risk and Compliance, SAP BusinessObjects

Rationalization of fraud. Individuals who commit financial reporting fraud possess a particular mindset that allows them to justify or excuse their fraudulent actions. CAQ discussion participants emphasized that personal integrity is critical in determining whether an individual will be prone to rationalize fraud. However, as the pressure or incentive increases, individuals may be more likely to construct some rationalization for fraudulent actions. For instance, in an environment of extreme pressure to meet corporate financial goals, members of management or other employees may conclude that they have no choice but to resort to fraud to save their own jobs or the jobs of others, or simply to keep the company alive "until the turnaround comes."

Where the motivation for fraud is more altruistic than personal—to save jobs or keep the company afloat—the pressure to commit fraud also can become the rationalization for it. The process of rationalization, like the slippery slope to fraud, often starts with justifying a small nudge to the boundaries of acceptable behavior but then deteriorates into a wholesale loss of objectivity. However, discussion participants noted that if employees understand that violations of the company's ethical standards will not be tolerated and if they see senior management living by strict ethical standards and consistently demonstrating high integrity, fraudulent behavior becomes difficult to rationalize.

Who Commits Fraud

The three sides of the fraud triangle are interrelated. Pressure can cause someone to actively seek opportunity, and pressure and opportunity can encourage rationalization. At the same time, none of these factors, alone or together, necessarily cause an individual to engage in activities that could lead to fraud. So what exactly is the profile of the person who commits fraud?

Theoretically, anyone has the potential to engage in fraud, and in fact some individuals who commit fraud previously had reputations for high integrity and strong ethical values. When pressures make individuals desperate and opportunity is present, financial reporting fraud becomes a real possibility. As one of the CAQ discussion participants observed, most people who commit fraud do not start with a conscious desire to do so: "They end up there because the world they are operating in has led them to a challenge beyond their capabilities."

Participants in the CAQ roundtable discussions also underscored that the greatest risk of financial reporting fraud relates to what has been called the "Achilles' heel" of fraud—the possibility of management override of controls.[7] Management is in a unique position to perpetrate fraud because it possesses the power to override controls, manipulate records, and facilitate collusion by applying pressure to employees and either enlisting or requiring their assistance.

> **The presence of a process to deter fraud doesn't eliminate the threat of people acting fraudulently.**
>
> **Charles M. Elson, JD,** Edgar S. Woolard, Jr. Chair, Professor of Law and Director of the John L. Weinberg Center for Corporate Governance, University of Delaware

In some situations, senior leaders do not perpetrate a fraud directly, but instead are indirectly responsible because they put inordinate pressure on subordinates to achieve results that are impossible without "cooking the books." At lower levels in the organization, individuals may not initially realize that they are committing fraud, but instead see themselves as simply doing what is expected to "make their numbers" or responding to the request of a supervisor.

POINT TO PONDER

Even under extreme pressure, only a small percentage of senior management actually commits fraud. Why do some buckle under pressure, and others not? Why and how do good people start down the slippery slope to fraud? Is it a function of circumstances? Or is it a fundamental character flaw?

Participants in the Financial Reporting Supply Chain and Their Roles in Mitigating the Risk of Financial Reporting Fraud

Management, boards of directors, audit committees, internal auditors, and external auditors are all key players in the public company financial reporting process, or "supply chain,"[8] with complementary and interconnected roles in delivering high-quality financial reporting, including the deterrence and detection of fraud.

Management

Members of management have the foremost role in the financial reporting process, with primary responsibility for the deterrence and detection of financial reporting fraud. They are responsible for the maintenance of accurate books and records and the design and implementation of an effective system of internal control over financial reporting. They are also responsible for evaluating and managing the company's business risks, including the risk of financial reporting fraud, and then implementing and monitoring compliance with appropriate internal controls to mitigate those risks to an acceptable level.

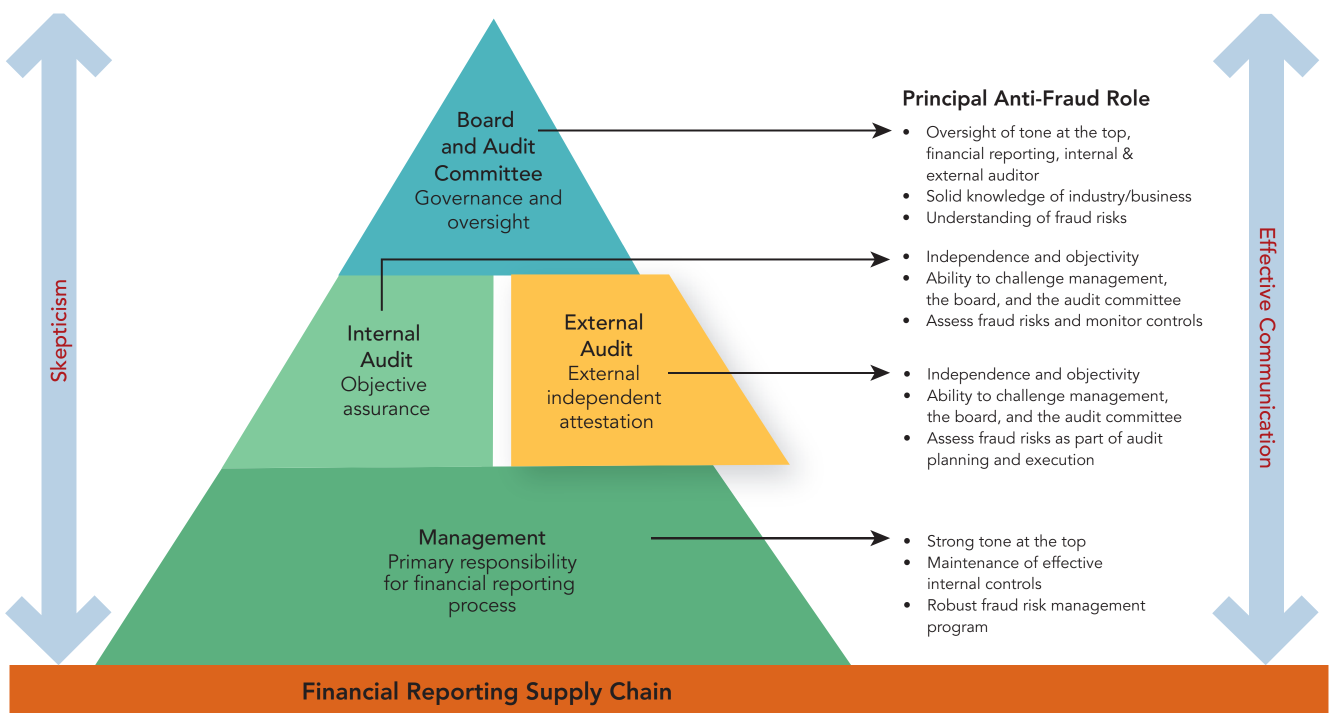
In the case of financial reporting fraud, critical controls start with the ethical tone at the top of the organization and include a strong code of ethics, fraud awareness training, hotline reporting mechanisms, monitoring tools, and processes to investigate, evaluate, and, where necessary, punish wrongdoing.

Senior management reports to the board of directors, with specific reporting to the audit committee on matters related to financial reporting and the risk of financial reporting fraud. While members of management have the foremost role in preventing and detecting fraud, they typically are involved when material financial reporting fraud does occur. According to CAQ discussion participants, in these situations, management is usually found ignoring the company's code of conduct and overriding internal controls. As a consequence, the roles of other parties in the financial reporting supply chain are critical in adequately addressing the risk of financial reporting fraud.

Boards of Directors and Audit Committees

As discussed in detail in several publications from the NACD,[9] the board of directors and audit committee of a public company have ultimate responsibility for oversight of the

Shared Responsibility to the Investing Public for Mitigating the Risk of Financial Reporting Fraud



business, including risk management and the financial reporting process.

The report of the NACD *Blue Ribbon Commission on Risk Governance,* like the Internal Control Framework developed by COSO, recognizes that the foundation for effective governance is board members who are objective, capable, and inquisitive, with a solid knowledge of the company's industry, business, and control environment. CAQ discussion participants stressed that audit committee members should have industry and entity knowledge, including a strong understanding of the economics of the business, in order to identify and understand business and financial risks that may increase the likelihood of fraud.

> **Most financial statement fraud involves senior management of the company—either directly, because they are the perpetrators, or indirectly, because they have imposed difficult-to-reach performance goals.**
>
> **Michael Oxley,** Former Member of Congress; currently Of Counsel, Baker & Hostetler LLP

The audit committee is responsible for overseeing the financial reporting process and controls, the internal audit function, and the external auditors, including the appointment of the company's external auditor. It oversees management's implementation of policies that are intended to foster an ethical environment and mitigate financial reporting risks. In this process, the audit committee has the responsibility to see that management designs, documents, and operates effective controls to reduce the risk of financial reporting fraud to an acceptable level. The Sarbanes-Oxley Act also makes the audit committee responsible for establishing mechanisms for the receipt, retention, and treatment of complaints received by the company regarding accounting, internal accounting controls, or audit matters, and confidential, anonymous submissions by employees of concerns regarding questionable accounting and auditing matters (generally referred to as the ethics or whistleblower program).

In addition, it is increasingly common for the audit committee to have a link with the compensation committee through overlapping members, joint meetings, or attendance of the audit committee chair at certain compensation committee meetings. The objective of this process is to satisfy both committees that the executive compensation structure provides sound incentives for achieving corporate strategies without unintentionally providing motivations for fraud or other unethical behavior. The focus on compensation structures will likely increase as a result of legislation and regulatory rules regarding corporate compensation policies and practices.

Internal Audit

Not all public companies have an internal audit function. However, where companies have an internal audit department, that group is described by The IIA as "an independent, objective assurance and consulting activity designed to add value and improve an organization's operations."[10] According to IIA standards, internal auditors should be independent of the activities they audit and free from interference in the conduct of their activities, and should exercise due professional care. Functionally, the chief audit executive commonly reports to the audit committee, with administrative reporting most often to the chief executive officer, general counsel, or chief financial officer.

Under IIA standards, internal audit is responsible, among other things, for evaluating the effectiveness of the company's risk management, control, and governance processes. CAQ discussion participants noted that internal auditors with such responsibilities should have sufficient knowledge to evaluate the risk of fraud and the manner in which it is managed by the organization.

Internal auditors also are responsible for evaluating risk exposures related to the reliability and integrity of financial information, and specifically "the potential for the occurrence of fraud and how the organization manages fraud risk." In this process, internal audit's role typically includes communicating to the board, audit committee, and management that internal controls, including controls to deter and detect fraud, are sufficient for the identified risks, and verifying that the controls are functioning effectively.[11] Internal audit also may assist management in identifying and assessing risks and the control environment.

In addition to these duties, internal audit may be involved in monitoring the whistleblower program, assessing compliance with the entity's code of ethics, and other activities in support of the organization's ethical culture.

External Audit

External auditors are independent of the organization they audit and provide a public report on the company's annual financial statements. Generally, for U.S. listed companies with $75 million or more in capitalization, the audit also includes an opinion on the effectiveness of the internal controls over financial reporting that management has implemented to address the risk of material misstatements in financial statements.

External auditors report directly to the audit committee, which engages them and oversees the conduct of the audit. Under PCAOB auditing standards, an audit is a detection mechanism specifically designed to assess fraud risk and detect *material* fraud: "An [external] auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud."[12]

Due professional care and skepticism are fundamental principles in everything an external auditor does. As part of their professional responsibilities, external auditors are required to discuss with the audit committee, as applicable, matters such as, but not limited to, those that may enter into the evaluation of the risk of financial reporting fraud, the adjustments that resulted from the audit, the auditor's judgment on the quality of the entity's accounting principles, significant accounting estimates, material weaknesses or significant deficiencies in internal controls identified during the audit, and disagreements with management, if any.[13] Because of their experience with a variety of companies, external auditors also are often in a position to provide useful perspectives on best practices in financial reporting and controls, including the mitigation of fraud risks.

It's quite plausible for senior management to rationalize fraudulent behavior: "We are not hurting anybody, we are not spending any money, we are protecting jobs, we think the business is going to turn around next year. We are just making sure that we are still here next year when the turnaround comes."

David Alexander, Director of Forensic Services, Smith and Williamson

Themes Related to Deterrence and Detection

The participants at the CAQ roundtable discussions and in-depth interviews agreed that pressure, opportunity, and rationalization are indeed key catalysts for financial reporting fraud. They also agreed that senior management has the primary responsibility for deterring and detecting fraud, working in concert with the board of directors and audit committee and the internal and external auditors.

A fundamental underpinning of any company's efforts to deter and detect fraud is a robust system of internal control. All key players in the financial reporting supply chain have some responsibility with respect to internal control systems. However, the risk of management override of internal controls and other factors means it is not enough to focus only on the design of a company's system of internal control. Thus, the crucial question is how the key players in the financial reporting supply chain, both individually and collectively, can effectively mitigate the risk that the three forces in the fraud triangle will lead to financial statement fraud.

Three themes or categories of fraud deterrence and detection measures emerged from the CAQ's discussions and

Deterring and Detecting Financial Reporting Fraud

Because of the inherent limitations on the effectiveness of controls and the possibility for the override of controls, the risk of fraud can be mitigated but not completely eliminated. Therefore, companies typically employ two strategies to mitigate fraud risks: controls that focus primarily on deterring potential fraud and controls to detect fraudulent activity.

Controls to deter fraud, such as a strong ethical tone at the top and a proactive fraud management program, are highly visible in the organization and are designed to ascertain and mitigate the forces that can enable fraud.

Detective controls generally operate in the background and focus on the timely identification of fraud that has occurred. Examples of detective controls include:

- Process controls such as reconciliations and physical count
- Technology tools to identify anomalies in accounting entries or activity
- Regular management or internal audit reviews of areas of activity (such as accounting estimates) susceptible to manipulation

Some controls, such as a whistleblower program, both deter fraud by their presence and help detect incidents of fraud.

interviews. These themes highlight the actions some companies already are taking to address the risk of financial reporting fraud and stimulate thinking about other potential approaches that may counter one or more of the motivators in the fraud triangle. These same themes are also reflected in recent research on the deterrence and detection of financial reporting fraud.

- First, the tone at the top, as it is reflected throughout a company's culture, is the primary line of defense and one of the most effective weapons to deter fraud
- Second, skepticism, or a questioning mindset on the part of all key participants in the financial reporting process, is a vital tool in evaluating fraud risk and in deterring and detecting potential financial reporting fraud
- Third, strong communication and active collaboration among all key participants are essential to a thorough understanding of the risks of financial reporting fraud and to an effective anti-fraud program

In developing specific next steps to advance efforts to deter and detect financial reporting fraud, it is instructive to focus on how each of the key groups in the financial reporting supply chain can embrace these themes in order to help mitigate the risk of financial reporting fraud. The following chapters discuss each of the themes and the related responsibilities of each stakeholder group—management, boards and audit committees, internal auditors, and external auditors.

2 CHAPTER

Tone at the Top

The Power of Corporate Culture

In both the CAQ's roundtable discussions and in-depth interviews, participants were unanimous that an organization's ethical culture is a decisive factor in mitigating the risk of fraudulent financial reporting, and that the corporate culture can either deter financial reporting fraud or implicitly condone it. Similarly, the PricewaterhouseCoopers *U.S. Supplement to the 2009 Global Economic Crime Survey* found that 72 percent of the responding executives identified issues relating to corporate culture as the root cause of increased economic crime.

A strong ethical culture starts with an organization's most senior leaders (thus the phrase "tone at the top") and cascades down through the entire organization to create—in the words of several participants in the CAQ roundtables and interviews—a "mood in the middle" and a "buzz at the bottom" that reflects and reinforces the company's operating values. Boards and audit committees, along with internal auditors, play vital roles in building and sustaining the organization's ethical culture.

Corporate culture influences all three sides of the fraud triangle. A strong ethical culture creates an expectation of doing the right thing and counteracts pressures to push the envelope to meet short-term goals. Likewise, an ethical culture typically supports well-designed and effective controls that diminish opportunities for fraud and increase the likelihood that fraud will be detected quickly. A culture of honesty and integrity can severely limit an individual's ability to rationalize fraudulent actions. However, if an employee is motivated by personal reasons such as greed or financial need, he or she may be impervious to the influence of corporate culture.

Tone at the Top Does Matter

The *Integrity Survey 2008–2009*, conducted by KPMG LLP, found that among companies with a comprehensive ethics and compliance program, 90 percent of the respondents described the environment as one where people feel motivated and empowered to do the right thing. In companies without a comprehensive ethics and compliance program, only 43 percent gave that response.

> **Tone at the top is a level of commitment to integrity, to doing the right thing at all costs despite the consequences such action may have on financial performance. Actions speak louder than words. Observing how leaders make decisions and act on a day-to-day basis is the most convincing evidence about the cultural reality at a company.**
>
> **Mark S. Beasley, Ph.D.,**
> Deloitte Professor of Enterprise Risk Management and ERM Initiative Director, North Carolina State University

Culture and Management

Of all the groups with a role in the financial reporting supply chain, management has the most critical role, because it is responsible for setting the tone at the top and establishing the culture and designing the systems that drive the organization. In the opinion of CAQ discussion participants, companies successful in building an ethical culture that deters fraud do so through a dual approach. First, they clearly state their ethical standards, and second, senior management visibly lives by those standards every day and reinforces them through the entire organization with appropriate systems and processes. The processes and criteria by which management makes decisions are crucial as they signal to the organization what is truly valued.

CAQ discussion participants stressed that an organization's tone at the top reflects its commitment to deterring and detecting fraud. If employees understand the organization's ethical expectations, believe that misconduct will not be tolerated, and see their senior leaders adhering strictly to the code of conduct, they are less likely to succumb to temptations to commit fraud and are more likely to report fraud if they see it. It's all about the example set by leadership, at all levels. In other words, the key is to walk the talk.

The Talk—Clear Policies and Messaging. According to CAQ discussion participants, to be effective, a company's ethical policies and standards should be unambiguously clear throughout all levels of the organization and in all geographic locations. It is senior leadership's responsibility to communicate these messages and continually reinforce them in a way that permeates through the entire organization. Employees need to hear the same messages not only from top leaders but also from their direct supervisors. As several participants in the CAQ roundtables and interviews pointed out, first-line supervisors have the most powerful and direct influence on the ethical judgments of employees. It is vital that the mood in the middle among these supervisors echo the company's talk on ethical values, so that the values become part of the daily conversation and the buzz at the bottom. Messages should emphasize each employee's duty to report questionable behavior, and performance goals and compensation plans should reinforce the primacy of ethical conduct.

> The choices the top makes are going to define what's acceptable ethically.
>
> **David Larcker, Ph.D.,** James Irvin Miller Professor of Accounting, Stanford University Graduate School of Business

> If we tell people we expect you to hit this number next quarter, and your bonus depends on it, that provides an incentive to meet it or to lie about meeting it.
>
> **Nell Minow,** Editor and Co-Founder, The Corporate Library

The following steps can strengthen an organization's messaging related to ethics and fraud deterrence:

- Ongoing, consistently branded corporate communications that are rolled out across multiple forms of media and:
  - Communicate clear messages about specific objectives
  - Make an emotional appeal
  - Are customized to different employee groups, geographies, and cultures
  - Are regularly assessed and updated
- Periodic ethics training for employees, tailored to the level and needs of different employee groups
- Fraud awareness training that educates employees on the characteristics of fraud and the behaviors and other red flags that may suggest fraudulent conduct
- Regular reviews of ethics policies to identify gaps and incorporate best practices

In addition, management (particularly senior management) should be sensitive to the pressures placed on employees. For example, management needs to consider the impact of compensation plans and performance expectations for employees, particularly in high-pressure situations. To avoid creating unintended pressure to falsify results, managers should be mindful of the stresses that their employees may feel in trying to "make the numbers," and try to design goals that are realistic and achievable. If the economic environment or other assumptions for original goals change, managers should consider modifying such goals accordingly.

The Walk—Actions Speak Louder Than Words. The "talk" about ethical behavior is important, but what really matters, according to CAQ discussion participants, is the example set by senior managers in their business and personal lives. A classic example is Enron, which at one time was lauded for its code of conduct and corporate governance programs, but which lacked leadership commitment to its principles. Moreover, the same standards of

Effective Codes of Conduct Are Based on Principles

"Exhaustively detailed codes of conduct encourage acquiescence and bureaucracy but fail to inspire employees with the spirit of ethical behavior. The most effective codes of conduct function not as rulebooks but as constitutions that detail the fundamental principles, values, and framework for action within an organization."

—LRN, *Ethics and Compliance Risk Management*, 2007 behavior should be applied to all levels of management, from first-level supervisors through the most senior ranks.

To integrate ethical behavior into the fabric of the company's culture, senior management's operating policies and decisions should reflect an unwavering commitment to the company's ethical values. Senior management should hold itself and all company personnel strictly accountable for compliance with ethical standards, and consequences for violations need to be consistently applied and clearly communicated.

> **Number one is talk the talk and number two is walk the talk by continuing to reinforce values in the discussions with the company personnel. Whether it's letters to the employees, letters to management, it's an ongoing process, not something where you paste something on the wall and walk away from it.**
>
> **John Trakselis, CPA,** Past President, Financial Executives International—Chicago Chapter

Annual employee surveys are excellent tools to obtain feedback on employees' understanding and perspective on ethics and compliance programs. As suggested by the consulting organization LRN, an effective employee survey should include questions that go beyond direct ethical issues and also ask about working conditions and overall job satisfaction, which often have significant ethical implications. The key is to craft questions that lead employees to comment on the organization's ethical culture. For example, a question might ask, do management and supervisors provide information and keep commitments? Responses may indicate whether management strictly abides by the rules or tends to push the limits of acceptable behavior.[14]

Fraud Risk Management Programs. In order to effectively deter and detect financial reporting fraud, management's activities also need to include a comprehensive fraud risk management program. Since the foundation for such a program is strong risk governance, many participants suggested that an appropriate member of senior management such as the chief risk officer, the ethics and compliance officer, or the general counsel should have explicit responsibility for the program, with audit committee oversight and ongoing monitoring of all of its aspects.

An effectively designed fraud risk management program starts with a formal assessment of fraud risk, which is tailored to the company, is updated annually, and evaluates incentives and opportunities to commit fraud. It also includes internal controls specifically designed to deter and detect financial reporting fraud.

The whistleblower program is one such control. Others include fraud awareness training for employees and robust controls over the financial reporting process. The program should also include a clear process for prompt investigation of allegations of fraud, along with swift corrective action if fraud is identified. The organization's response to fraud should send a clear signal that fraud will not be tolerated, at any time, in any place, or by any level of employee.[15]

The 2010 ACFE *Report to the Nations on Occupational Fraud and Abuse* found that, on average, the frauds in the study continued for two years from the point they began to the point they were detected, with some running consider-

Elements of Effective Fraud Risk Management

- A formal fraud risk management program that includes a code of ethics supported by the tone at the top; clear roles and responsibilities for the board, the audit committee, management, and internal audit; and fraud awareness and reporting training for all employees
- A comprehensive fraud risk assessment that addresses incentives and opportunities to commit fraud and the likelihood and significance of each potential fraud risk, including the risk of management override of controls
- Activities and controls to deter and detect fraud, including the consideration of fraud risk in the development of the annual internal audit plan and in the execution of internal audit engagements
- Processes for the investigation of potential frauds and for corrective action when necessary

Summarized from *Managing the Business Risk of Fraud: A Practical Guide*, by American Institute of Certified Public Accountants, Association of Certified Fraud Examiners, and and The Institute of Internal Auditors, 2008.

ably longer. Companies need to make continuous improvements in order to increase the likelihood that fraud is detected on a timely basis. The *Fraud Risk Checklist* published in 2008 by the Financial Executives Research Foundation provides an example of a structured approach for management to identify and mitigate potential risk factors for fraudulent financial reporting.[16]

Whistleblower Programs. Many CAQ discussion participants underscored the importance of a readily accessible whistleblower reporting mechanism, such as a hotline, to receive reports of concerns about ethics violations or potential fraud. The 2010 Institute of Internal Auditors Knowledge Alert on *Emerging Trends in Fraud Risks* identified a tool for confidential reporting as one of the key components of a fraud management program.

The Sarbanes-Oxley Act makes the audit committee specifically responsible for establishing and overseeing a confidential reporting mechanism. To promote its use, the Act requires that the procedures allow for reports to be submitted confidentially and anonymously. In order for the program to be effective, it is also important that there be a clear record of non-retaliation. Participants emphasized that allegations involving senior management and/or financial irregularities should be escalated to the audit committee immediately. In addition, for the whistleblower program to have credibility, reported matters should be investigated promptly, and meaningful penalties should be imposed when violations are confirmed. Numerous surveys reveal that many employees still fail to report fraud or other misconduct because they either fear retaliation or do not believe that management will do anything to stop the unethical behavior.[17] For that reason, some CAQ discussion participants suggested that companies consider sharing a summary of information about hotline reports and their disposition within the organization.

While the participants in the roundtable discussions noted that a large majority of calls to hotlines relate to relatively minor human resources matters, a meaningful percentage of reports identify serious misconduct or fraud. According to both the 2010 ACFE *Report to the Nations on Occupational Fraud and Abuse* and the 2009 PricewaterhouseCoopers survey, *Economic Crime in a Downturn,* fraud was much more likely to be detected by tips than by any other method. The ACFE study reported that "approximately half of fraud tips came through a hotline when that

Boards and audit committees should set a culture in the organization of highly ethical behavior and communicate to those within the organization that if there is a problem, a vehicle exists for those inside the organization to report it in an anonymous way so that they don't feel jeopardized.

Michael A. Moran, Vice President, Global Markets Institute, The Goldman Sachs Group, Inc.

Features of a Well-Designed Whistleblower Program

- Option for anonymity
- Organization-wide (global) and available 24/7, ideally by telephone, with professionally-trained interviewers in all local languages
- Single hotline for all ethics-related issues
- Dual dissemination of the information received so that no single person controls the information, with criteria for immediate escalation where warranted, and for notification of the audit committee when financial irregularities or senior management are involved
- Case management protocols, including processes for the timely investigation of hotline reports and documentation of the results
- Management analysis of trends and comparison to norms
- Data security and retention policies and procedures
- Customization to comply with the laws of foreign jurisdictions and to address cultural differences
- Ongoing messaging to motivate everyone in the organization, as well as vendors, to use the hotline

Summarized from *Best Practices in Ethics Hotlines,* T. Malone and R. Childs, The Network, 2009 mechanism was available, and . . . 63 percent of the hotline reports involved fraud by a manager or executive." The PricewaterhouseCoopers report found that 48 percent of frauds were discovered as a result of tips or hotline reports and concluded: "Whistle blowing is a tangible example of a benefit that companies can realize from building a culture where fraud is not tolerated and those that report it have no fear of retaliation."

POINT TO PONDER

The Dodd-Frank Act of 2010 directs the SEC to reward whistleblowers. Because tips are an effective means for identifying misconduct, should companies consider a reward system for tips leading to discovery of fraud?

Challenges of Cross-Cultural Differences. Public companies are increasingly global in scope, and multinational corporations face special challenges in trying to foster a consistent level of ethics across different countries and cultures. Instilling a consistent standard of ethical behavior is much more complex than just translating an ethics code or fraud deterrence program into different local languages. It requires capturing the nuances of meaning in the local language and tailoring policies to local customs, as well as determining that controls are implemented and compliance consistently monitored despite geographic distance. Creating a uniform ethical culture also means evaluating cultural differences that may create pressures, opportunities, or rationalizations for fraud that are different from those typical in the United States.

For example, it may be necessary to explain how the organization's policies are more restrictive than the law or common practice in a particular country. Certain expectations for behavior, such as a prohibition on "facilitation payments," may be more restrictive in the United States than what is normally acceptable in another jurisdiction. As one CAQ discussion participant pointed out, "Process bridges cultures. Checks and balances, transparency, and process will be more successful than any speech on ethics."

> **The audit committee needs to set the tone at the top. It should make it clear to management and the auditors that there is only one standard for how we do things, and that is the right way—and that doesn't mean the right way only if it's material."**
>
> **J. Michael Cook,** Audit Committee Chair, Comcast Corporation

Culture and Boards and Audit Committees

Under the Sarbanes-Oxley Act, audit committee members must be independent of management and must have a designated financial expert or explain why they do not. In addition, the audit committee is responsible for oversight of the confidential whistleblower program and for engaging and overseeing the external auditors. These responsibilities, along with the role of the board and audit committee in overseeing risk management, give boards and audit committees a central role in an organization's efforts to discourage and uncover fraud.

Among other things, boards and audit committees play a key role in reinforcing an appropriate tone at the top for both corporate conduct and risk management by making ethical conduct an overriding priority, including establishing a code of ethics specifically for the board that is consistent with the corporate code. CAQ discussion participants emphasized that the board and audit committee should make themselves visible in the organization as proponents of high ethical standards. Most importantly, the board and the audit committee support the tone at the top by putting the right senior management team in place as their representatives to the organization.

Boards and audit committees have the responsibility to assess the integrity of senior management on an ongoing basis. In particular, audit committees should be aware of and monitor the risk of management override of internal controls as a part of their oversight of the financial reporting process. Audit committees should pay specific attention to leveraging the internal audit function. According to 45 percent of the respondents to the *2009 Global Integrity Survey* by *Compliance Week* and Integrity Interactive Corporation, internal audit plays an essential role in gauging the overall level of integrity and ethics within a company. Another 33 percent indicated that internal audit contributes to this effort.

Executive compensation. Boards (through their compensation and audit committees) should evaluate whether incentive compensation plans—especially those for senior management—are aligned with the company's ethical values and long-term business goals. However, the *2009 Global Integrity Survey* noted that "half of the respondents said they don't tie integrity to executive compensation." Because incentive structures can influence the ethical environment within organizations, several of the CAQ discussion participants stated that links between compensation and audit committees should be strengthened. Additionally, the audit committee may consider evaluating the performance and compensation of the chief audit executive as well as employment or termination decisions for both the chief financial officer and chief audit executive.

Compensation goals are good when they balance short-term and long-term goals and objectives, and they look at the behavior that someone who is striving to achieve that goal is going to exhibit. Overemphasis on short-term goals can create incentives that do not foster ethical behavior.

Kathy Swain, Vice President, Internal Audit, The Allstate Corporation

POINT TO PONDER

How can the board and audit committee identify when a previously strong tone at the top starts to shift and morph into something more receptive to inappropriate risk-taking or behavior?

Culture and Internal Audit

The internal audit function has a key role in communicating, reinforcing, and evaluating the ethical culture of an organization, including testing compliance with anti-fraud programs and other controls. Internal auditors can be extremely valuable as "eyes and ears" for management as well as for the board and audit committee. The more substantive and visible their activities to support ethical standards and assess the risk of fraud, the greater their impact will be.

According to The IIA, a best practice for internal audit departments is to have a direct line of reporting to the audit committee. Along those lines, it is encouraging that 84 percent of respondents to a 2009 survey by the global internal auditor community AuditNet indicated that the chief audit executive had unrestricted direct access to the audit committee.[18]

To be effective, the internal audit staff should be knowledgeable and experienced, with the necessary expertise and tools, including fraud detection training and fraud specialists on staff, where possible. Moreover, the ability of internal audit to support the deterrence and detection of financial reporting fraud depends on the board and senior management sending a clear message on the importance of internal audit activities (for instance, by requiring all levels of management to respond to internal audit inquiries and findings).

Ten Principles for Effective Board Oversight of Risk

The 2009 report of the NACD *Blue Ribbon Commission on Risk Governance* identifies the following ten principles for effective board oversight of a company's risk management system. These principles are intended to serve as a foundation for a comprehensive risk management system tailored to the specific characteristics and needs of each individual company:

1. Understand the company's key drivers of success.
2. Assess the risk in the company's strategy.
3. Define the role of the full board and its standing committees with regard to risk oversight.
4. Consider whether the company's risk management system is appropriate and has sufficient resources.
5. Work with management to understand and agree on the types of risk information the board requires.
6. Encourage a dynamic and constructive risk dialogue between management and the board, including a willingness to challenge assumptions.
7. Closely monitor the potential risks in the company's culture and its incentive structure.
8. Monitor critical alignments of strategy, risks, controls, compliance, incentives, and people.
9. Consider emerging and interrelated risks to help prepare for what's around the corner.
10. Periodically assess the board's risk oversight processes.

One of internal audit's roles is to challenge the design of a company's internal controls and to monitor their effectiveness, particularly in major risk areas. In some organizations, internal audit is tasked with managing the compliance and ethics program. Whether or not they manage the program directly, internal audit should consider issues raised through the program in the context of their role related to financial reporting fraud. Commonly, internal audit is charged with working with the audit committee in administering the program and determining that any response is rapid and appropriate.

Beyond these specific responsibilities, The IIA's Research Foundation, in a recent book by James Roth, *Best Practices: Evaluating the Corporate Culture,* has suggested that the greatest value that internal audit can provide is in the evaluation of "soft controls," which are "the informal, intangible levers of control such as tone at the top, the organization's ethical climate, and management's philosophy and operating style" that, taken together, constitute the corporate culture. The particular focus should be on identifying any gaps between the company's stated ethical and cultural values and the way the company actually operates. Roth presents various case studies to support his conclusion that root cause analysis of major frauds and business failures "leads inevitably to the culture of the organization," and that serious weaknesses in formal or "hard" controls usually have a soft control weakness as the underlying root cause. The evaluation of soft controls hinges on gathering employee perceptions and confirming whether they are accurate.

POINT TO PONDER

If internal audit is expected to assess and challenge the tone at the top of a company, is the function structured properly to maintain its objectivity? For example, if the career path of most internal audit staff (including in some cases the chief audit executive) is to rotate back into the mainstream organization, is there a conflict of interest that potentially compromises objectivity?

Culture and External Audit

Professional standards require the external auditor to obtain an understanding of the company's system of internal control as part of the audit planning process. To this end, an auditor considers several factors such as management's philosophy and operating style (including the integrity and ethical values practiced by management), the company's commitment to competence, the effectiveness of the board and audit committee's oversight, and the company's human resource policies and practices (including compensation arrangements). These factors encompass the auditor's evaluation of an organization's tone at the top and overall corporate culture, including incentives or pressures that may exist for management to engage in fraudulent financial reporting. This evaluation is an important consideration in the auditor's overall design of the audit and the assessment of the risks of material misstatement of the financial statements due to error or fraud.

Because external auditors work with a wide variety of people across many parts of a company's operations, they often have the opportunity to gain insights at various levels about the company's culture, as well as on the effectiveness of internal controls. CAQ discussion participants suggested that external auditors can leverage their experience from working with multiple clients—assessing a broad range of control systems, practices, and organizational structures—to identify possible warning signs and concerns that should be discussed with the company's board and audit committee. By analyzing past frauds and understanding the conditions in which they came about, auditors serve as a useful resource for boards, audit committees, and members of management who may not have a similar breadth of experience or training.

POINT TO PONDER

As part of their regular communications with audit committees, should external auditors discuss the observations related to a company's tone at the top and its culture (including management integrity) obtained as part of the annual audit and quarterly reviews?

SUMMARY OF CONSIDERATIONS RELATED TO TONE AT THE TOP

For Management

1. Clearly articulate the organization's ethical standards in a set of core values and a formal code of conduct, and hold all personnel strictly accountable for compliance with the code. Enforce discipline for violations consistently across all levels of the organization.

2. Set the right tone at the top. Embed the code of conduct into the fabric of the company's culture by "walking the talk," leveraging communications and training, and reinforcing the standards at all levels of the company through appropriate management systems and processes.

3. Build a mood in the middle that mirrors the tone at the top. Emphasize the critical role of supervisors in setting the tone for their direct reports and their teams by both word and deed.

4. Establish a comprehensive fraud risk management program, including a whistleblower program and fraud awareness training for all employees. Consider cultural differences in other jurisdictions. Assign responsibility for the fraud risk management program to an appropriate member of senior management, and assess the effectiveness of the program at least annually.

5. Internally communicate the actions taken related to tips received from the whistleblower program.

6. Design incentive compensation programs so that their structure does not unintentionally provide a potential incentive for misconduct or fraud.

7. Set and enforce high standards for compliance with internal controls over financial reporting, including diligent monitoring and the provision of adequate resources to comply with established procedures.

For Boards and Audit Committees

1. Personally "walk the talk" of the company's core values and code of conduct. Be visible outside the boardroom, and interact personally with employees at various levels to obtain their perceptions of the corporate culture and reinforce high ethical standards.

2. Adopt a strong tone of compliance, communicate it to the entire organization, and hold management accountable. Take decisive action against any member of senior management who does not adhere to the company's ethical standards and code of conduct.

3. Regularly review key strategies and business plans and assess the achievability of goals in light of current circumstances. Goals should be structured to avoid a rigid short-term focus that might push management or employees to commit fraud.

4. Establish a regular process for assessing management integrity, and do not let this activity become perfunctory.

5. Approve the internal audit charter and the annual work plan to ascertain that it is aligned with and addresses the audit committee's needs and its expectations for internal audit.

6. Review and understand the results of reports to the whistleblower program, focusing on complaints that involve senior management or reflect on the ethical culture of the company. Leverage the internal audit function.

7. Evaluate ways to strengthen relationships between the audit committee and the compensation committee—either through overlapping membership, joint meetings, or audit committee chair attendance at relevant meetings of the compensation committee—with the objective of designing compensation packages that promote ethical behavior, as well as providing incentives to meet financial goals and build long-term shareholder value.

8. Consider the role of the audit committee in evaluating the performance and compensation of the chief audit executive, as well as the benefits of adopting a policy that the audit committee concurs in employment or termination decisions for both the chief financial officer and the chief audit executive.

For Internal Audit

1. Work proactively with the audit committee to develop a clear, shared vision of the internal audit function in order to reinforce the integrity and importance of the function throughout the company.

2. Require basic fraud detection training, including the detection of financial reporting fraud, for all internal auditors.
3. If warranted, consider allocating one internal audit position for a fraud specialist, ideally someone with appropriate experience and certifications.
4. Take an active and visible role in supporting the ethical culture, including evaluating hotline results, conducting ethics surveys of employees, and collaborating with other departments to address results and remediate applicable findings. Analyze year-over-year changes in key metrics.
5. Evaluate soft controls and the corporate culture, including assessment of the company's fraud risk management program, and involve appropriate departments in addressing the results.
6. Establish or otherwise ensure there is a formal process to educate the board and audit committee on the risks and red flags of financial reporting fraud, with a particular focus on the risks of management override of controls.

For External Auditors

1. Inquire of management and the audit committee how they push the tone at the top down through the entire organization and integrate it into the culture at all levels. Focus the discussion on the details of the company's communications and training programs, including the tools that help each level of management reinforce the desired messages with its direct reports.
2. Discuss with management and the audit committee how they monitor the company's culture to confirm that it does in fact reflect the tone at the top. Ask what tools and methodologies are used, such as employee surveys and reports summarizing hotline results, and what is done with the results.
3. Proactively engage the audit committee in discussing observations related to the tone at the top obtained as part of the audit, as well as insights into ways to identify possible red flags and warning signs.
4. Provide management, the board, and the audit committee with examples of leading practices related to ethics communications, hotlines, and programs to mitigate the risk of financial reporting fraud.

CHAPTER 3

Skepticism
An Enemy of Fraud

Skepticism—a questioning mindset and an attitude that withholds judgment until evidence is adequate—promotes risk awareness and is inherently an enemy of fraud. Participants in the financial reporting supply chain naturally believe that the organizations with which they are associated have integrity, and are therefore predisposed to trust each other. But this bias to trust can also inhibit raising questions, and it is all the more reason why stakeholders should consciously adopt an attitude of skepticism.

Skepticism involves the validation of information through probing questions, critical assessment of evidence, and attention to red flags or inconsistencies. Skepticism does not mean a lack of trust. Rather, it means, "I trust you, but my responsibilities require me to confirm what you and others tell me." Some refer to this as the "trust but verify" approach.

The starting point for effective skepticism is the recognition that even the best system of internal control has weaknesses, and fraud can occur. Effective skepticism involves knowledge of the company's business, including the risks associated with the industry and company, the manner in which the company manages those risks, and the company's overall internal control structure.

While skepticism is a concept that is primarily used in the context of the professional skepticism of an external auditor, CAQ discussion participants stressed that the ability to question and critically assess information is a skill that also is essential for boards, audit committees, management, and internal auditors in the conduct of their responsibilities. Academic research has confirmed a positive relationship between skepticism characteristics and fraud detection skills.[19]

By exercising skepticism and promoting the cultural expectation that questions are healthy and appropriate, management, the board, the audit committee, internal audit, and external audit can work to counteract the three forces of the fraud triangle and mitigate the risk of financial reporting fraud. As one of the CAQ discussion participants stated, "That is one of the biggest deterrents to fraud—knowing that people are interested, are listening, and will react."

Skepticism and Management

CAQ discussion participants agreed that effective managers rely on the use of skepticism in virtually all activities. Whether in designing strategy, assessing risks, setting goals, reviewing progress, or evaluating results, managers need a questioning attitude.

For instance, management's assessment, design, and implementation of internal controls over financial reporting should acknowledge that the organization can be susceptible to fraud, despite past experiences or beliefs about employee integrity. As a result, an appropriate system of internal controls should create checks and balances and should include processes to continually monitor and reevaluate the effectiveness of controls.

In reviewing operating and financial reports, discussion participants suggested that management follow up when results seem inconsistent with expectations or with economic trends in the company's industry sector. In effect, skepticism involves management stress-testing its own decisions and assumptions about financial reporting processes and controls, as well as the decisions and work of subordinates, to gain confidence that nothing significant has been missed and that things are what they seem. Through this process, management can offset many fraud risk factors. Skepticism also tends to diminish the perception of opportunity for fraud and the ability to rationalize fraudulent behavior.

Skepticism and Boards and Audit Committees

CAQ discussion participants suggested that the audit committee needs to be keenly aware that business pressures can find their way to personnel from many different directions. Once these pressures and influences come into play, management can lose objectivity and start down the road of reporting improper results. Over time, the accounting determinations can become even more aggressive and ultimately can lead to large-scale financial fraud.

As CAQ discussion participants continually emphasized, the foundation for effective governance and oversight by the board and its committees is skepticism, in the form of vigorous and probing questions of management, the internal auditors, and the external auditors to find sources of bias. To do so, the audit committee first needs to acknowledge the possibility that bias may exist and that something may go awry, potentially resulting in fraud. Good board and audit committee members know what techniques to use to evaluate management, how to ask the right questions, when to drill down with follow-up questions, and how to identify and assess possible "uncomfortable" behavior. Probing questions are essential both to test the integrity of management and to communicate a clear expectation of ethical behavior. At times, that approach may be uncomfortable. However, as one CAQ discussion participant stated, "Comfort is not a requisite for directors. . . . I don't need to be comfortable. I just need to be able to ask the hard questions." Asking the same questions of various people is another tool that audit committees can employ to assess the consistency of answers and obtain multiple perspectives.

Board members should be a little more skeptical and less trusting. Not that they don't trust the company's management. But they should do their own due diligence and recognize they have to keep their eye on these things by spending more time making judgments, connecting the dots and following through by asking more questions.

Peggy Foran, Vice President, Chief Governance Officer, and Corporate Secretary, Prudential

To exercise skepticism effectively, as CAQ discussion participants underscored, members of the board and the audit committee need to have a thorough knowledge of the company's business, including its industry, its competitive environment, and the key risks that may affect management's ability to accomplish objectives. The board and audit committee can benefit from focused conversations with management and the internal and external auditors on the risks of financial reporting fraud. In particular, boards and audit committee members need to understand how their organization makes money. Because revenue manipulation and the acceleration of future results into the current period are the most common forms of financial reporting fraud, under-

Six Characteristics of Skepticism

- **Questioning Mind**—A disposition to inquiry, with some sense of doubt
- **Suspension of Judgment**—Withholding judgment until appropriate evidence is obtained
- **Search for Knowledge**—A desire to investigate beyond the obvious, with a desire to corroborate
- **Interpersonal Understanding**—Recognition that people's motivations and perceptions can lead them to provide biased or misleading information
- **Autonomy**—The self-direction, moral independence and conviction to decide for oneself, rather than accepting the claims of others
- **Self-Esteem**—The self confidence to resist persuasion and to challenge assumptions or conclusions

Summarized from R. Kathy Hurtt, "Development of a Scale to Measure Professional Skepticism," *Auditing: A Journal of Practice and Theory,* May 2010.

standing what drives the company's revenue is critical to deterring and detecting financial reporting fraud.

KPMG's 2007–2008 *The Audit Committee Journey* survey of public company audit committee members found that only 28 percent were "very satisfied" that they understood management's processes to identify and assess significant risks facing the company, and only 21 percent were satisfied with the information they received on the organization's risk management efforts. Because it is necessary to understand business risks in order to manage them, these findings raise concerns.

Although the complexity of the information that boards and audit committees must absorb can be daunting, particularly given the relatively short amount of time available, there are resources and tools that can be of assistance. For instance, the internal audit function, the external auditors, ethics and compliance personnel, and reports and statistics from the company's internal whistleblower program can provide in-depth information that is both nuanced and candid. Where appropriate, boards and audit committees should also have ready access to outside experts and legal counsel.

Board members need to be trained to ask the kinds of questions that are very probing without sending a signal that there is no trust in anything being done.

William J. White, former Chairman of the Board, Bell & Howell Company

The role of an audit committee member is to oversee the financial reporting activities of the company, not to directly manage the company. In particular, audit committee members should understand the exposure to management override of controls and take action to monitor those risks and mitigate the possibility that an override could occur, or, if it did occur, that it could go undetected. Skepticism openly displayed, in combination with a solid understanding of the business and current environmental opportunities and challenges, forms the foundation for effectively monitoring the risk of management override.[20] Audit committee members should be comfortable in asking probing questions and should use internal auditors, external auditors, ethics and compliance personnel, or others as sources of information to supplement what they learn directly.

POINT TO PONDER

If skepticism can be defined as "trust but verify," would audit committee members benefit from training to enhance their ability to evaluate non-verbal cues during discussions with management?

Monitoring the Risk of Management Override—Key Steps for Boards and Audit Committees

- Understand the business and industry, including:
  - Key drivers of revenue and earnings and related key performance indicators
  - Factors that may threaten management's ability to achieve its goals and strategies
  - Pressures created by the company's incentive compensation programs
- Brainstorm with management, external auditors, and counsel in an executive session to identify fraud risks
- Assess the tone at the top and the corporate culture through an evaluation of corporate communications on ethics and the results of employee surveys
- Establish an effective whistleblower hotline
- Develop a broad information network that extends beyond senior management to include internal auditors, external auditors, the compensation committee, and key employees such as business unit leaders, marketing and sales personnel, and corporate managers just below the senior management level. Interaction with key employees during company meetings or other functions can provide the opportunity to build relationships and establish confidential dialogues.

Summarized from M*anagement Override of Internal Controls: The Achilles' Heel of Fraud Prevention,* American Institute of Certified Public Accountants, 2005.

Inquiring about Financial Reporting Fraud—A Guide for Audit Committees

The mere mention of the word fraud can be enough to stall a conversation or at best elicit a canned response. Also, compliance-oriented questions do not tend to yield a productive discussion. Shifting the focus away from compliance and toward the sources of influence on the financial reporting system that can cause fraud has proven to be an effective method of starting a productive fraud discussion.

During a conversation between the audit committee and management, the internal auditors, or the external auditors, the audit committee should be alert for indications of where follow-up is needed to validate processes and controls that deter or detect fraud. The list of questions below is not intended to be all-inclusive; rather, it represents sample inquiries designed to elicit information from management or the auditors about fraud risks without asking about fraud directly.

These examples are not a checklist of questions to be posed word for word. Rather, they were developed by the Center for Audit Quality to advance the thinking of audit committees around the most likely sources of weakness, with a particular eye for business pressures that may influence accounting judgments or decisions. It is important that audit committees fine tune these questions to fit the organization and recognize that these suggestions are only the starting point for a conversation.

1. What are the potential sources of business influence on the accounting staff's judgments or determinations?
2. What pressures for performance may potentially affect financial reporting?
3. What about the way the company operates causes concern or stress?
4. What areas of the company's accounting tend to take up the most time?
5. What kind of input into accounting determinations does non-financial management have?
6. What are the areas of accounting about which you are most worried?
7. What are the areas of recurring disagreement or problems?
8. How does the company use technology to search for an unnatural accounting activity?
9. If a *Wall Street Journal* article were to appear about the company's accounting, what would it most likely talk about?
10. If someone wanted to adjust the financial results at headquarters, how would they go about it and would anything stop them?

These questions are intended to assist in obtaining a better understanding of the sources of influence on the financial reporting system that may affect the objectivity of accounting judgments or determinations.

The reason for this focus is that fraudulent financial reporting rarely starts with dishonesty. Rather, it typically starts with pressures for performance that influence accounting judgments and thereby introduce bias into the system.

A key objective of the audit committee, therefore, is to uncover potential sources of bias or influence on accounting judgments.

Skepticism and Internal Audit

Internal auditors can be a valuable resource to provide boards and audit committees with insight into the company's ethical culture, the effectiveness of its internal controls, and its exposure to management override. IIA standards call for the internal auditor to have an impartial and unbiased attitude, and internal audit's professional responsibilities include evaluating both the potential for fraud in an organization and how the organization manages the risk of fraud.

Appropriate skepticism is critical to this role—it assists an internal auditor in reviewing audit evidence, verifying management's assertions, assessing the sufficiency of management's fraud risk assessment, and evaluating the design and operating effectiveness of internal controls intended to detect or deter fraud. Additionally, skepticism reinforces alertness to information or conditions indicating that a material financial misstatement, intentional or otherwise, may have occurred. Because of their constant presence in the company and their intimate knowledge of the company's culture, personnel, and operations, internal auditors are particularly well situated to identify early indicators of potential fraud, including indicators that the external auditor normally might not be in a position to identify.

Specific factors that internal auditors should consider in the conduct of their work include:

- The risk that senior management may override internal controls
- Known external and internal matters affecting the entity that may create incentives to commit fraud or enable rationalizations for committing fraud
- The need for persuasive evidence that thoroughly probes into complex issues

The 2010 IIA survey on *Emerging Trends in Fraud Risk* found that internal audit performs a variety of consulting and assurance activities that add value to the organization's fraud risk management efforts, including the following top four: conducting tests to determine if fraud is present in areas identified with potential risk (73 percent); evaluating the design and operation of internal controls (71 percent); taking an active role in support of the organiza-

Professional Responsibilities of Internal Auditors Related to Fraud

The International Professional Practices Framework (IPPF) of The IIA specifically requires that internal auditors address the risk of fraud:

- "The internal audit activity must evaluate the potential for the occurrence of fraud and how the organization manages fraud risk." (IPPF 2120.A2)
- "The internal audit activity must evaluate the probability of significant errors, fraud, noncompliance, and other exposures when developing the engagement objectives." (IPPF 2210.A2)

In addition, The IIA recently issued a practice guide that identifies the following specific internal audit responsibilities related to fraud:

- Consider fraud risks in assessing internal control design and determining audit steps to perform
- Have sufficient knowledge of fraud to identify red flags that fraud may have been committed
- Be alert for opportunities for fraud, such as control deficiencies
- Evaluate whether management is actively retaining responsibility for oversight of the fraud risk management program
- Evaluate any indicators of fraud and recommend investigation when appropriate
- Communicate with the board regarding fraud risks and prevention and detection programs, as well as any incidents of actual fraud

Internal Audit and Fraud Practice Guide, The Institute of Internal Auditors, 2009 tion's ethical culture (66 percent); and performing its own fraud risk assessment (61 percent).

In addition to exercising skepticism in the conduct of their activities, internal audit should be alert for any attempts on the part of management to limit or influence the scope or nature of its activities. For instance, as one CAQ discussion participant pointed out, WorldCom management appeared to purposely divert their internal audit function away from its audit responsibilities and into a cost-cutting program, thus effectively eliminating a key internal control over financial reporting fraud.

Skepticism and External Audit

Professional auditing standards call for external auditors to exercise professional skepticism, which is defined as "an attitude that includes a questioning mind and a critical assessment of audit evidence."[21] For an external auditor, the exercise of professional skepticism means evaluating and challenging audit evidence and remaining alert for information that suggests that a material misstatement of the financial statements may have occurred. Additionally, external auditors should apply professional skepticism when they consider the risk that management may override internal controls,[22] and take that risk into account when formulating judgments about the nature and extent of audit testing. Through this level of scrutiny, auditors increase not only the *likelihood* that fraud will be detected but also the *perception* that fraud will be detected, which together reduce the risk of fraud.

In order to emphasize the importance of skepticism in the conduct of an audit, professional standards require members of the audit engagement team to discuss the potential for material misstatement due to fraud.[23] At a minimum, these discussions should involve the key members of the engagement team (including the auditor with final responsibility for the audit, i.e., the lead engagement partner) and should generate an exchange of ideas, or "brainstorming," about the following:

- How and where the engagement team believes a company's financial statements could be susceptible to material misstatement due to fraud
- How management could perpetrate and conceal fraudulent financial reporting
- How assets of the company could be misappropriated
- The importance of maintaining the proper state of mind throughout the audit regarding the potential for material misstatement due to fraud

Of course, the importance of skepticism does not stop with the completion of the brainstorming session. Rather, it is integral to the development of the audit plan. For instance, professional standards require auditors to perform analytical procedures on a company's financial results to identify any unusual transactions or trends that may indicate matters that have financial statement and audit planning implications.[24] These procedures require the auditor to have a level of knowledge about the company and the industry sufficient to evaluate whether the results suggest that a fraud risk exists. Skepticism also is integral to the execution of the audit plan, as auditors must be alert to indications of fraud risks as audit evidence is evaluated and modify the audit plan accordingly.

Because professional skepticism is a critical skill for external auditors, academic preparation and continuing professional training programs are important tools for instilling and reinforcing the exercise of skepticism, particularly in the assessment of fraud risk, including the risk of management override of controls, and in the design of audit testing to respond to identified risks. Face-to-face meetings to obtain information are often helpful—in part because they provide an opportunity to assess body language and other non-verbal communications.

In addition to the role of skepticism in the conduct of the external audit, discussion participants suggested that external auditors can be a valuable resource for boards and audit committees by providing insights on the company's ethical culture, the effectiveness of its internal controls, and its exposure to management override, including information on leading practices in similar companies. The external auditors can also advise the board and audit committee on questions to ask management.

POINT TO PONDER

Whistleblower tips can serve as an important source of information about fraud and other misconduct. How can external auditors leverage data regarding the nature and frequency of whistleblower tips to enhance their fraud risk assessment?

SUMMARY OF CONSIDERATIONS RELATED TO SKEPTICISM

For Management

1. Acknowledge that fraud can occur and consider such risks as part of the company's risk assessment process.

2. Build skepticism into the culture. Establish a clear expectation that all levels of management will question and challenge all results for which they are responsible, with the specific intent of confirming that corporate standards of accuracy, excellence, and ethics were met.

3. Aggressively pursue the root cause of any deficiencies in controls, and take remedial steps promptly.

4. Monitor your company and benchmark it with others in the industry for the purpose of identifying indicators of fraud.

For Boards and Audit Committees

1. Confirm that all board and audit committee members have a strong understanding of the company's business and its industry. Leverage outside training and consultants as necessary, with the objective of enabling all members of the board and audit committee to ask probing questions about strategy and operations. Audit committee members should also have a working understanding of financial reporting, even if they are not financial experts.

2. Ask questions of management, internal auditors, and external auditors to elicit potential concerns related to opportunities or incentives for financial reporting fraud.

3. Use face-to-face meetings whenever possible to obtain information, encourage open discussion, and assess nonverbal communications such as body language.

4. Actively oversee those aspects of the company's strategy and risk management program that affect financial reporting, with a specific focus on risks that could potentially create incentives for financial reporting fraud.

5. Question management in depth about its program for managing fraud risk, focusing on areas where management has identified the greatest vulnerabilities, including the risk of management override of controls. Ask management to explain how those vulnerabilities are being addressed and consider utilizing internal audit to evaluate the effectiveness of management's activities.

6. Leverage the internal and external auditors as key resources. Have regular, confidential meetings between the audit committee and the chief audit executive, and perhaps separately with other senior members of the internal audit department, as well as executive sessions with the external auditor.

For Internal Auditors

1. Suggest to the board and audit committee specific ways in which internal audit can provide support, with a particular focus on the risk of financial reporting fraud.

2. Take the lead role in assessing the company's program to mitigate the risk of financial reporting fraud, and report annually to the audit committee on that assessment.

For External Auditors

1. Based on the fraud risk assessment developed in planning the audit, proactively suggest questions that the board and audit committee may want to ask management.

2. Regularly evaluate the audit firm's internal communications and training programs to confirm that they adequately address the exercise of professional skepticism and the assessment of fraud risk.

3. Reinforce the importance of interviewing and inquiry skills in the audit process, including consideration of nonverbal communications.

4. Emphasize the value of corroboration as a means of obtaining sufficient audit evidence, and provide guidance on mechanisms and methodologies such as company communications for obtaining corroborative information.

5. Consider including in the brainstorming sessions individuals outside of the engagement team with industry expertise and those who have experience with situations involving financial reporting fraud.

6. Consider face-to-face meetings to obtain information, in order to encourage open discussion and assess nonverbal communications.

7. Encourage the academic community to strengthen the auditing curriculum's focus on professional skepticism and techniques for fraud detection.

4 CHAPTER

Communications

Knowledge Sharing to Deter and Detect Fraud

Each of the participants in the financial reporting supply chain has a separate but interconnected role in the shared responsibility to deter and detect fraud. Fulfilling this responsibility successfully requires leveraging each party's complementary activities by sharing information and concerns and identifying any gaps in the collective efforts to mitigate the risk of financial reporting fraud. To this end, CAQ discussion participants emphasized the importance of regular, open, and robust communications across the financial reporting supply chain. They also encouraged collaboration to stimulate continuous improvement in efforts to deter and detect financial reporting fraud. Effective communications are a self-reinforcing cycle. Frequent, high quality communications enhance the knowledge and understanding of all parties, resulting in better questions and a constantly improving communications process.

The audit committee is a hub for coordinating many financial reporting communications because it has primary reporting lines from management, the internal auditor, and the external auditor. It is the responsibility of the audit committee to see that these communications work well.

Effective communications require both time and commitment. Adequate time on the board and audit committee agendas for all priority matters promotes open, two-way discussion and critical challenge rather than a superficial or minimalist approach. CAQ discussion participants noted that it is important to foster a culture of inquiry so that board and audit committee members are not intimidated or discouraged from asking questions or challenging management or other board or committee members. In particular, executive sessions of the board and audit committee with the chief financial officer and key employees, the internal auditors, and the external auditors are invaluable in providing all parties with a broad perspective on the company's financial reporting environment and the reporting culture, including whether controls are respected and complied with faithfully.

The KPMG Audit Committee Institute's *The Audit Committee Journey* reports that "the audit committee's executive sessions with the external audit partner are viewed [by 75 percent of respondents] as most productive, followed closely by internal audit and the CFO." The report goes on to state "The external auditor continues to be the best source of suggestions for improving the audit committee's organization and activities."

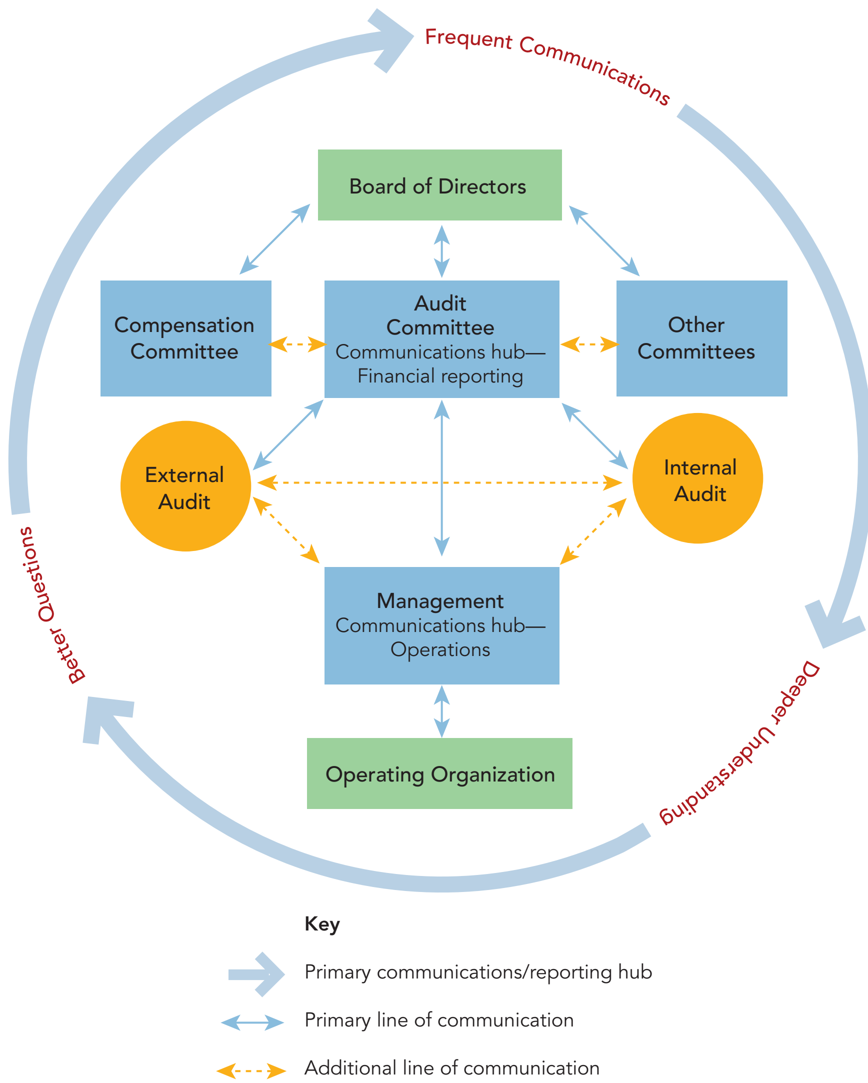
Executive sessions provide the opportunity for the audit committee to go beyond the review of financial reports and have frank dialogue on "soft" topics such as corporate values, management style, and the potential for financial reporting fraud. For example, when the audit committee is discussing the financial statements with management, or the results of internal audit engagements with the chief audit executive, committee members may want to consider specifically asking about and probing the controls over financial reporting, including controls over management override.

Audit committees should also consider expanding their communications beyond senior management. Conversations with operating personnel and with financial management below the

It's a risky business when you don't have all these parties that are committed to and responsible for the audit working in tandem and securing results that are greater than the sum of the parts.

Richard Thornburgh, Former U.S. Attorney General, currently Of Counsel, K&L Gates, LLP

Financial Reporting—Lines of Communication



top level can provide valuable insights into the company's culture and the risks it is facing. Audit committees should consider asking questions such as "Were you pressured to do anything?" and "What are you uncomfortable with?" If the person knows that his or her response will be held in confidence, they will be more inclined to share concerns.

POINT TO PONDER

There is almost never enough time on board and audit committee agendas, and yet time constraints should not curtail critical discussions. What are the best techniques to ensure that all issues of concern to the board and audit committee are adequately discussed? One approach is to minimize opening remarks and formal presentations. What else works well?

Most participants in the CAQ discussions and interviews agreed that the Sarbanes-Oxley Act requirement that the audit committee engage the external auditor has facilitated the discussion of difficult issues and allowed for more effective oversight of the financial reporting process. External auditors are required to report annually to the audit committee on a variety of matters, and audit committees are one source of input into an auditor's assessment of the risk of material misstatement in a company's financial statements and the related audit response. Discussion participants emphasized that these communications should not be viewed as a routine compliance exercise, but rather as the starting point for an in-depth discussion of any matters that concern either the audit committee or the external auditors.

Of course, not all communications run through the audit committee; communications also regularly occur between management and the internal auditor, management and the external auditor, and the internal auditor and the external auditor. In most organizations, the internal audit function reports administratively to a member of senior management, and internal audit's activities serve a key role in helping management assess the effectiveness of the control environment and the risk of financial reporting fraud. Internal audit should consider management's risk assessment and other input in developing its audit plan, although management should not limit the scope of internal audit's work. Internal audit's findings and recommendations can provide management with important insights in assessing whether the intended tone at the top and ethical messages have permeated throughout the organization's culture.

CAQ discussion participants noted that the objectives and professional standards of internal and external auditors with respect to the risk of financial reporting fraud are similar and complementary. Internal audit's evaluation of management's fraud risk assessment, as well as the results of internal audit's testing of internal controls, are important to the external auditor's assessment of fraud risk and its planning of the external audit. Similarly, the results of the external audit may also inform the ongoing internal audit plan. Continuous communication about these matters is mutually beneficial to both parties and is essential to avoiding gaps in the effort to mitigate the risks of financial reporting fraud.

Participants in the financial reporting supply chain should work diligently to establish and maintain an environment of open and ongoing communication. As the discussion participants underscored, the goal is to share knowledge, insights, and concerns to enhance the collective efforts of all supply chain participants and make the whole greater than the sum of its parts. Communications also foster collaboration among all stakeholders and stimulate continuous improvement in efforts to deter and detect financial reporting fraud.

Required External Auditor Communications to Audit Committees

PCAOB auditing standards require the external auditor to communicate various matters to the audit committee, including, but not limited to, the following:[25]

- Significant accounting policies, management judgments, and accounting estimates
- The auditor's judgments about the quality, not just the acceptability, of the company's accounting principles
- Significant difficulties, if any, encountered during the audit
- Uncorrected misstatements that were determined by management to be immaterial, individually and in the aggregate
- Audit adjustments arising from the audit, either individually or in the aggregate, that in the auditor's judgment could have a significant effect on the entity's financial reporting process
- Significant internal control deficiencies or material weaknesses and disagreements with management

SUMMARY OF CONSIDERATIONS RELATED TO COMMUNICATIONS

For Management

1. Encourage two-way communication between managers and employees at all levels in the organization.

2. Work proactively to make sure that boards, audit committees, internal auditors, and external auditors are well informed on a timely basis about the company's operations, strategies, and risks, including the latest developments.

For Boards and Audit Committees

1. Routinely ask questions of management, internal auditors, and external auditors to elicit indications of potential concerns related to incentives or opportunities for financial reporting fraud.

2. Work to connect with the organization outside the boardroom. Seek opportunities to interact with managers, employees, vendors and customers to enhance knowledge of the company and possible risks of financial reporting fraud.

For Internal Auditors

1. Establish a regular schedule of face-to-face meetings with senior management, the audit committee, and the external auditor to exchange insights and perspectives. Explore opportunities for the external auditor to leverage the work of internal audit.

For External Auditors

1. Proactively promote opportunities for robust conversations between the external auditors and the audit committee on relevant matters, including the factors considered in the auditor's assessment of fraud risk and the company's approach to developing significant accounting estimates. Seek an executive session with the audit committee at all meetings to encourage candid conversation, even when there are no special concerns or significant issues to discuss.

2. Work with boards and audit committees to vary the nature and focus of their questions to management, internal auditors, and others such as key employees in order to extend the breadth and depth of the discussion and obtain an enhanced understanding of the business and the potential risks of financial reporting fraud.

5 CHAPTER

The Case for Collaboration

Increasing Effectiveness Across the Financial Reporting Supply Chain

Effective communication among the key stakeholders in the financial reporting supply chain is critical to successfully deterring and detecting fraudulent financial reporting. While supply chain participants in individual organizations work to deter and detect financial reporting fraud one company at a time, the professional organizations that represent each major stakeholder group, including FEI for management, NACD for boards and audit committees, The IIA for internal auditors, and the CAQ for public company auditors, are actively engaged in the effort to mitigate the risk of financial reporting fraud broadly for all companies. Each of these groups historically has developed methods, practices and tools to assist in mitigating the risk of financial reporting fraud, and they are continually developing new ideas for study and conducting research to further advance the skills of their constituents.

As illustrated throughout this report, not unlike the members of a sports team, each of the players in the financial reporting supply chain has a distinct role in the deterrence and detection of financial reporting fraud. But it is not enough for each group to excel on its own. In order to become a winning team, each player must share his or her knowledge of the opponent and work together.

As part of its vision to enhance investor confidence in the capital markets, the CAQ acts to convene and foster collaboration with other stakeholders to advance the discussion of critical issues. In that capacity, the CAQ has identified areas of focus for future collaboration among participants in the financial reporting supply chain. The goal is to establish consensus on what needs to be done and to develop resources to assist stakeholder efforts, as well as to identify areas where further focus and study are warranted. The overall objective is to advance the abilities of all stakeholders to deter and detect financial reporting fraud through a spectrum of specific activities, such as those described below, to share ideas, sponsor research, and perhaps develop new tools and methodologies.

Joint Commitment to Collaborate in Anti-fraud Efforts

The CAQ's efforts to convene representatives of stakeholders on the issue of fraud deterrence and detection led to the development of this report and provide a mechanism for ongoing communication, coordination, and collaboration among all participants in the financial reporting supply chain. The continuation of this interaction should facilitate the exchange of experiences and perspectives, and could also go further to help identify ways to leverage existing resources and develop and prioritize future joint activities to advance the deterrence and detection of financial reporting fraud. The goal of such efforts would be to enhance thinking around areas critical to fraud deterrence and detection, as well as potential tools targeted to the roles and responsibilities of each stakeholder group.

FEI, NACD, and The IIA, organizations that already are actively engaged in efforts to mitigate the risk of financial reporting fraud, plan to collaborate with the CAQ. Our efforts also will provide the opportunity for collaboration with additional organizations whose constituents have specialized knowledge in particular areas, which should contribute to fraud deterrence and detection. We anticipate that the results of these efforts will be transparent and inclusive, and will be communicated broadly to key stakeholder groups. Such communication could be through white papers or other written materials, as well as the delivery of webcasts and conferences. In addition, we intend these efforts to complement the activities of the PCAOB's Financial Reporting Fraud Resource Center and look forward to opportunities for collaboration with the new Center.

Based on the observations highlighted throughout the report, our initial collaborative efforts will focus on four broad areas.

1. Advance the Understanding of Conditions That Contribute to Fraud

A wealth of research has been conducted on the motivations for fraudulent behavior and the related rationalization process. As detailed more fully in Chapter 1, the fraud triangle provides a simple model of three factors that contribute to fraud: pressure, opportunity, and rationalization. However, the fraud triangle does not explain one critical phenomenon: why one person takes actions to distort financial results, while another in a similar situation does not.

Management, boards and audit committees, and internal and external auditors could benefit from tools and resources that help operationalize the vast amount of behavioral research on the factors that move an individual past the temptation or opportunity to commit fraud. Working together, the major stakeholder groups can leverage their current guidance, analyze past frauds, pursue further areas of research, and develop new materials to enhance understanding about the pre-conditions and indicators of financial reporting fraud. Building awareness in these areas could assist all the financial reporting supply chain participants in identifying fraud risks and potential red flags, while at the same time further strengthening internal control systems.

An important and related area for consideration is the human conditioning that can prevent people from finding a fraud even when they sense that something may not be right. It will be important to discuss and understand what environmental and behavioral factors may discourage an individual from asking the next question that might unveil the fraud.

2. Promote Additional Efforts to Increase Skepticism

As discussed more fully in Chapter 3, the ability to critically assess, question, and corroborate information is an essential skill for management, boards, and audit committees, and is expected of internal audit and the external auditor. All stakeholders could benefit from efforts to enhance the ability to think critically and skeptically about the information presented to them. Stakeholder collaboration in this area would facilitate improvements in the deterrence and detection of fraud.

For example, a key method used by stakeholders to identify potential indicators of concern is the review and analysis of a company's financial results and related complex information. Developing tools or techniques to enhance the ability of management, internal auditors, external auditors and audit committee members to evaluate a company's financial results (by comparison, for instance, with management budgets, analyst expectations, and the results of industry peers) could facilitate more robust discussions and help identify potential indicators of concern. Frameworks to assist in assessing other potential fraud risk factors, such as compensation arrangements, could further improve the review process.

In addition, enhancing stakeholders' communication abilities, including their interview and inquiry skills, would complement the other efforts described above. Such efforts to strengthen skepticism could also include examining behavioral traits or other environmental factors that may impede the application of effective skepticism.

3. Moderate the Risks of Focusing Only on Short-Term Results

Long-term value creation for investors is the responsibility of management, boards, and audit committees. However, this goal may conflict with the incentives that are introduced by short-term pressures, such as internal profit targets, short-term performance goals in compensation plans, or analysts' expectations and the demands of stock traders and intermediaries who focus on short-term stock price performance. An emphasis on short-term results can create pressures on multiple levels of an organization, which can increase the risk of financial reporting fraud. It is important that management, boards and audit committees, and internal and external auditors remain sensitive to the presence of and potential risks associated with short-term goals and take steps to mitigate such risks.

Through collaborative activities, stakeholders can share perspectives on short-termism, its role in the accomplishment of an organization's objectives (including those of investors), and its impact on a company's operating environment and system of internal controls. This awareness and sharing of experiences could allow all stakeholders to better understand and evaluate potential risks and mitigating factors.

4. Explore the Role of Information Technology in Facilitating the Deterrence and Detection of Fraudulent Financial Reporting

Given its central role in systems of internal control, information technology is another area where all participants in the financial reporting supply chain may be able to benefit from sharing experiences and ideas. Information technology can be instrumental in deterring and detecting fraud. On the other hand, technology can also be exploited to facilitate fraud if not adequately controlled.

Ongoing discussion of the benefits and challenges related to information technology and its impact on deterring and detecting financial reporting fraud could help all stakeholder groups identify and address technology-related risks for fraud. In addition, it would be beneficial to consider whether additional or improved use of technology would enhance internal control structures and assist in identifying potential fraudulent activity. For example, increased use of technology could facilitate the operation and monitoring of controls, mitigate the risk of human intervention, and provide information about the effectiveness of controls, all of which would assist stakeholders in the effective conduct of their oversight responsibilities.

Among the areas where stakeholders could share information and consider future action are the management and auditing challenges created by electronic business communications and recordkeeping, where the majority of information used for business decisions is stored electronically (e.g., via e-mail or electronic documents stored centrally or on individual hard drives). Exploring ways to tap into and leverage electronic information to identify possible indicators of fraud could enhance the ability to detect fraudulent behavior. Focused collaboration could produce new ideas and tools, such as data queries and analyses that could be applied to general ledgers, sub-ledgers, e-mails, vendor master files, and other electronic repositories to assist in identifying potential fraud.

A potential barrier to realization of the full benefits of the use of technology to enhance a company's ability to leverage electronic information is the disparate nature of the information systems companies use to maintain their books and records. No standard format exists for maintaining general ledger information, and that lack of standardization may inhibit the development of common tools that could be used across platforms to access, monitor, and analyze ledger data for various attributes that could contribute to fraud detection. Stakeholders in the financial reporting supply chain may want to consider exploring whether a standardized data format for key elements of a company's general ledger would significantly facilitate the development of tools to assist in monitoring, analyzing, and evaluating financial information.

CONCLUSION

The CAQ's roundtable discussions and interviews underscored that there is no silver bullet solution to deterring and detecting fraud. Every group in the financial reporting supply chain plays a key role—from senior management to boards, audit committees, internal auditors, and external auditors. While the Sarbanes-Oxley Act has led to significant improvements in financial reporting processes, controls and overall corporate governance, all supply chain participants must maintain a vigilant watch for the presence of the elements of the fraud triangle.

The observations in this report represent the beginning of a focused and coordinated long-term effort to advance the deterrence and detection of financial reporting fraud, with the ultimate goal of benefiting investors, other users of financial reports, and participants in the capital markets. The CAQ is especially pleased that FEI, NACD, and The IIA have agreed to join with us to collaborate and advance this complex and vital issue. The CAQ looks forward to working with all stakeholders in these endeavors.

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22. See note 12 above.
23. See note 12 above.
24. See note 12 above.
25. See note 13 above.

Appendix 1
Participants in CAQ Discussions and In-Depth Interviews

NOTE: An asterisk (*) indicates discussion participants who also provided in-depth interviews.

SAN FRANCISCO

Discussion Moderator: Terence Smith

Tim Arnold, Chief Auditor, Visa, Inc.

David Bernstein, Former Chief Accounting Officer, CBS Interactive

John A. Bohn, Commissioner, California Public Utilities Commission

David F. Bond, Senior Vice President, Finance and Control, Safeway Inc.

Gregory Burke, Chair, California Society of Certified Accountants

John Diaz, Editorial Page Editor, San Francisco Chronicle

John Doyle, Director, Board of Directors, Xilinx, Inc.

Roger F. Dunbar, Chair of the Audit and Risk Management Committee, and Chair of the Finance Committee, Silicon Valley Bank; Global Vice Chair-Retired, Ernst & Young Global

Marc J. Fagel, San Francisco Regional Director, Securities and Exchange Commission

Cindy Fornelli, Executive Director, Center for Audit Quality

Scott Grossfeld, Chief Executive Officer, Association of Certified Fraud Examiners *

Michele Hooper, Co-Vice Chair, Governing Board, Center for Audit Quality; President & Chief Executive Officer, The Directors' Council

Charles T. Horngren, Ph.D., Edmund W. Littlefield Professor of Accounting, Emeritus, Stanford University Graduate School of Business

David F. Larcker, Ph.D., James Irvin Miller Professor of Accounting, Stanford University Graduate School of Business*

Norman Marks, Vice President, Governance, Risk and Compliance, SAP BusinessObjects *

Kay Matthews, Vice Chair, Pacific Northwest Managing Partner, Ernst & Young

Mary Hartman Morris, Investment Officer, Corporate Governance—Global Equities, California Public Employees' Retirement System

Mark Niswonger, Partner, KPMG LLP

Kenneth E. Scott, Ralph M. Parsons Professor of Law and Business, Emeritus, Stanford Law School

Cynthia L. Zollinger, President and Chief Executive Officer, Cornerstone Research, Inc.

NEW YORK

Discussion Moderator: Terence Smith

Rick Antle, Ph.D., William S. Beinecke Professor of Accounting, Yale School of Management

Ian Ball, Ph.D., Chief Executive Officer, International Federation of Accountants *

Thomas F. Bongiorno, Vice President and Corporate Controller, Quest Diagnostics Incorporated

Neri Bukspan, Executive Managing Director and Chief Quality Officer, Standard & Poor's

Douglas R. Carmichael, Ph.D., Claire and Eli Mason Professor of Accountancy, Baruch College

Thomas J. Colligan, Former Director and Chair of the Audit Committee, Schering-Plough Corporation; currently Member of the Audit Committee, Office Depot and Targus

J. Michael Cook, Chair of the Audit Committee, Comcast Corporation *

Cynthia Cooper, Chief Executive Officer, CooperGroup LLC

Cindy Fornelli, Executive Director, Center for Audit Quality

Jay Goldberg, Vice President, Internal Audit, Take Two Interactive Software, Inc.

Trevor S. Harris, Ph.D., The Arthur J. Samberg Professor of Professional Practice and Co-Director, Center of Excellence in Accounting and Security Analysis, Columbia Business School

Michele Hooper, Co-Vice Chair, Governing Board, Center for Audit Quality; President & Chief Executive Officer, The Directors' Council

Susan Lister, Partner, National Director of Auditing, BDO USA, LLP *

Mary Louise Mallick, First Deputy Comptroller, State of New York

Michael A. Moran, Vice President, Global Markets Institute, The Goldman Sachs Group, Inc. *

Robert E. Moritz, Chairman and Senior Partner, PricewaterhouseCoopers LLC

Howard J. Mosbacher, Senior Vice President, General Auditor and Chief Information Security Officer, The Hartford Financial Services Group, Inc.

Floyd Norris, Chief Financial Correspondent, The New York Times

Walt Pavlo, President, Etika, LLC

Janet Pegg, Senior Accounting Analyst, Encima Global LLC

Richard Thornburgh, Of Counsel, K&L Gates, LLP *

Tom Warga, North American Director, Board of Directors, The Institute of Internal Auditors

David B. Wyshner, Executive Vice President and Chief Financial Officer, Avis Budget Group, Inc. *

CHICAGO

Discussion Moderator: Terence Smith

Peggy Foran, Former Executive Vice President, General Counsel and Secretary, Sara Lee Corporation; currently Vice President, Chief Governance Officer and Corporate Secretary, Prudential *

Cindy Fornelli, Executive Director, Center for Audit Quality

Brenda Gaines, Chair of the Audit Committee, Office Depot

Varda Goldman, Corporate Vice President and General Counsel, PCTEL, Inc.

Michele Hooper, Co-Vice Chair, Governing Board, Center for Audit Quality; President & Chief Executive Officer, The Directors' Council

Bob Kueppers, Deputy Chief Executive Officer, Deloitte LLP *

Michael Lev, Associate Managing Editor for Business, Chicago Tribune

John Markese, Ph.D., President and Chief Executive Officer, American Association of Individual Investors

Steve Priest , President, Ethical Leadership Group

Mark Sullivan, Former Managing Director and Head of Loss Prevention, Kroll; currently Principal, Forensic Accounting & Investigative Services, Grant Thornton LLP

Kathy Swain, Vice President, Internal Audit, The Allstate Corporation *

Scott Taub, Managing Director, Financial Reporting Advisors, LLC *

John Trakselis, Past President, Financial Executives International — Chicago Chapter; Chair, Vistage International Inc. *

Curtis Verschoor, Emeritus Research Professor, School of Accountancy and MIS, DePaul University

Linda Vincent, Ph.D., Associate Professor in Accounting Information and Management, Kellogg School of Management, Northwestern University

Joe Weber, Formerly Chief of Correspondents, Chicago Bureau, BusinessWeek; currently Associate Professor, College of Journalism and Mass Communications, University of Nebraska-Lincoln

William J. White, Former Chairman of the Board, Bell & Howell Company; currently Professor, Robert R. McCormick School of Engineering and Applied Science, Northwestern University *

Russ Wieman, Formerly National Managing Partner of Audit and Advisory Services, Grant Thornton LLP; currently Chief Financial Officer, Grant Thornton LLP

WASHINGTON DC

Discussion Moderator: Terence Smith

Peter Barnes, Senior Washington Correspondent, Fox Business News

Mark S. Beasley, Ph.D., Deloitte Professor of Enterprise Risk Management and ERM Initiative Director, North Carolina State University *

Nancy Zucker Boswell, President and Chief Executive Officer, Transparency International USA

Keith T. Darcy, Executive Director, Ethics and Compliance Officer Association

Joseph T. Doyle, Member of the Audit Committee, USEC, Inc.

Charles M. Elson, Edgar S. Woolard, Jr. Chair in Corporate Governance, and Director of the John L. Weinberg Center for Corporate Governance, University of Delaware *

Cindy Fornelli, Executive Director, Center for Audit Quality

Craig Greene, Partner, McGovern & Greene, LLP

Stephen D. Harlan, Chair of the Audit Committee, Sunrise Senior Living, Inc.; ING Direct Bank; and MedStar Health Inc.

Roderick M. Hills, Chairman, Program on Governance, Center for Strategic and International Studies; Partner, Hills Stern & Morley LLP

Michele Hooper, Co-Vice Chair, Governing Board, Center for Audit Quality; President & Chief Executive Officer, The Directors' Council

Suzanne M. Hopgood, Chair of Nominating/Governance Committee, Acadia Realty Trust

David M. Johnson, Executive Vice President and Chief Financial Officer, Fannie Mae

Henry Keizer, Deputy Chairman and Chief Operating Officer, KPMG LLP

Dan Lasik, Hospitality Industry Partner, Ernst & Young LLP

Nell Minow, Editor and Co-Founder, The Corporate Library *

John F. Olson, Partner, Gibson, Dunn & Crutcher LLP

Michael G. Oxley, Of Counsel, Baker & Hostetler LLP *

Zoe-Vonna Palmrose, Ph.D., PricewaterhouseCoopers Auditing Professor, University of Southern California Marshall School of Business

Robert M. Tarola, President, Right Advisory LLC; formerly Chief Financial Officer, W.R. Grace & Co.

Glenn W. Tyranski, Senior Vice President, Financial Compliance, NYSE Euronext

Ann Yerger, Executive Director, Council of Institutional Investors

LONDON

Discussion Moderator: Clive Crook

David Alexander, Director of Forensic Services, Smith and Williamson *

Felicity Banks, Head of Business Law, ICAEW

Ruth Bender, Ph.D., Reader in Corporate Financial Strategy, Cranfield University School of Management

Paul Boyle, Former Chief Executive, Financial Reporting Council

Peter Butler, Founder, Partner & Chief Executive Officer, Governance for Owners LLP

David Clarke, Detective Superintendent, Head of National Fraud Intelligence Bureau, City of London Police

Valerie Dias, Executive Vice President & Chief Risk and Compliance Officer, Visa Europe

Helenne Doody, Formerly Fraud Risk Management Specialist, Chartered Institute of Management Accountants; currently Senior Manager — Business Banking Fraud, Barclays

Jonathan Fisher QC, Barrister, 23 Essex Street Chambers and Fraud Advisory Panel *

Richard Fleck, CBE, Chairman, Auditing Practices Board, Financial Reporting Council

Cindy Fornelli, Executive Director, Center for Audit Quality

Robert Hodgkinson, Executive Director, Technical, ICAEW

Michele Hooper, Co-Vice Chair, Governing Board, Center for Audit Quality; President & Chief Executive Officer, The Directors' Council

Jennifer Hughes, Senior Markets Correspondent, Financial Times

Christopher Humphery, Professor of Accounting, Manchester Business School

Martyn Jones, National Audit Technical Partner, Deloitte LLP

Craig Josephson, Regional Anti-Money Laundering Officer, EMEA Northern Trust

Ronald Kent, Executive Vice President, NYSE Euronext

Steve Maslin, Head of External Professional Affairs, Grant Thornton UK LLP

Allan McDonagh, Director, Hibis Europe Limited

Liz Murrall, Director, Corporate Governance, Investment Management Assoc.

Michael O'Higgins, Chairman, Audit Commission

Jeff Pott, General Counsel, AstraZeneca

Peter Smith, Chairman of the Audit Committee, Associated British Foods

Myles Thompson, Technical Audit Partner, KPMG LLP, UK

Nicolas Veron, Research Fellow, Bruegel

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Appendix 3
Methodological Statement

This report was created using a combination of primary research techniques and secondary studies on a variety of topics dating back approximately 10 years.

The primary research techniques employed for this study were as follows:

- The Center for Audit Quality convened moderated roundtable discussions in four U.S. cities and London with more than 100 invited representatives of key stakeholders, including corporate executives, members of boards and audit committees, internal auditors, external auditors, fraud specialists, investors, regulators, and academics.
- In-depth interviews with a subset of representatives from the stakeholders who participated in the moderated discussions were conducted by an outside independent research firm.

The information gleaned from the moderated roundtable discussions and interviews has been supplemented by secondary research conducted by a number of organizations (see Bibliography).

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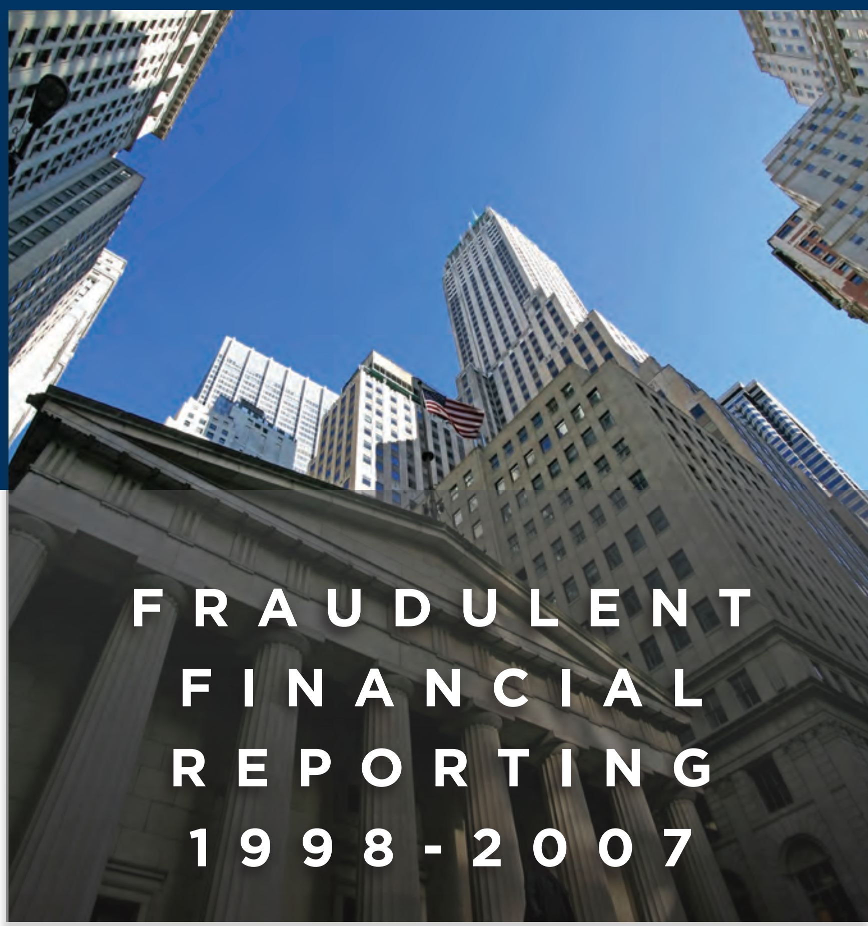

FRAUDULENT FINANCIAL REPORTING 1998-2007

An Analysis of U.S. Public Companies

By

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Preface

This project was commissioned by COSO, which is dedicated to providing thought leadership through the development of comprehensive frameworks and guidance on enterprise risk management, internal control, and fraud deterrence designed to improve organizational performance and governance and to reduce the extent of fraud in organizations. COSO is a private sector initiative, jointly sponsored and funded by the following organizations:

American Accounting Association (AAA)

American Institute of Certified Public Accountants (AICPA)

Financial Executives International (FEI)

Institute of Management Accountants (IMA)

The Institute of Internal Auditors (IIA)

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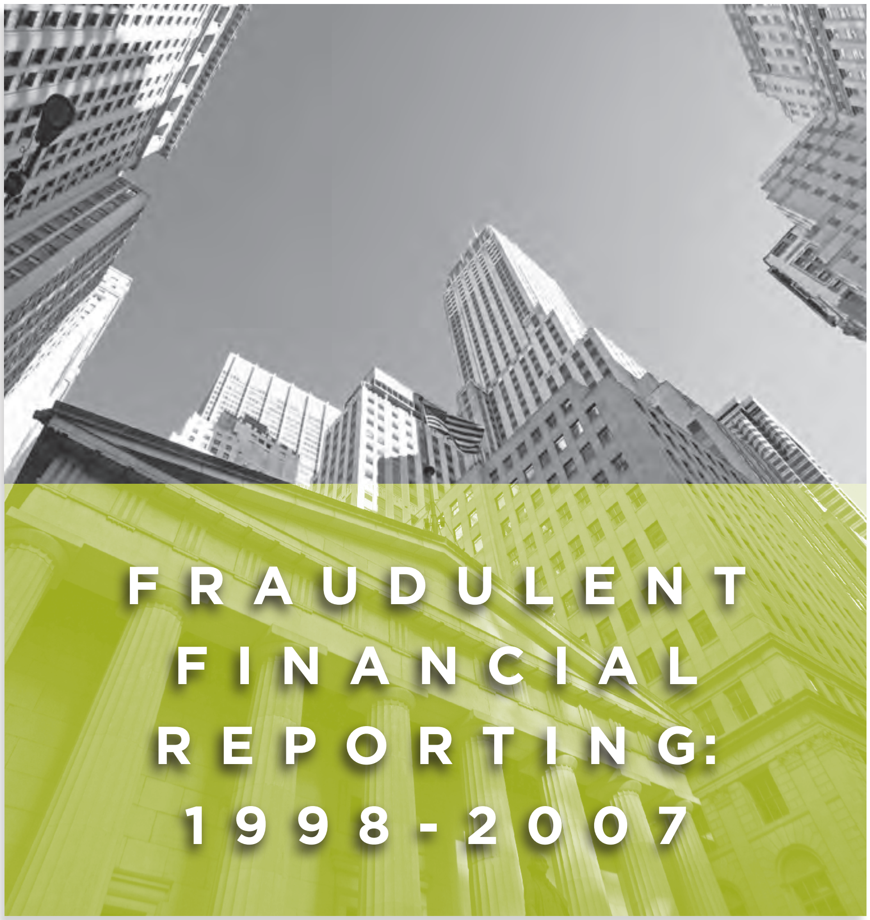

FRAUDULENT FINANCIAL REPORTING: 1998-2007

An Analysis of U.S. Public Companies

Research Commissioned by

COSO

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Executive Summary

COSO sponsored this study, *Fraudulent Financial Reporting: 1998-2007*, to provide a comprehensive analysis of fraudulent financial reporting occurrences investigated by the U.S. Securities and Exchange Commission (SEC) between January 1998 and December 2007. This study updates our understanding of fraud since COSO's 1999 issuance of *Fraudulent Financial Reporting: 1987-1997*. Some of the more critical findings of the present study are:

- There were 347 alleged cases of public company fraudulent financial reporting from 1998 to 2007, versus 294 cases from 1987 to 1997. Consistent with the high-profile frauds at Enron, WorldCom, etc., the dollar magnitude of fraudulent financial reporting soared in the last decade, with total cumulative misstatement or misappropriation of nearly $120 billion across 300 fraud cases with available information (mean of nearly $400 million per case). This compares to a mean of $25 million per sample fraud in COSO's 1999 study. While the largest frauds of the early 2000s skewed the 1998-2007 total and mean cumulative misstatement or misappropriation upward, the median fraud of $12.05 million in the present study also was nearly three times larger than the median fraud of $4.1 million in the 1999 COSO study.
- The companies allegedly engaging in financial statement fraud had median assets and revenues just under $100 million. These companies were much larger than fraud companies in the 1999 COSO study, which had median assets and revenues under $16 million.
- The SEC named the CEO and/or CFO for some level of involvement in 89 percent of the fraud cases, up from 83 percent of cases in 1987-1997. Within two years of the completion of the SEC's investigation, about 20 percent of CEOs/CFOs had been indicted and over 60 percent of those indicted were convicted.
- The most common fraud technique involved improper revenue recognition, followed by the overstatement of existing assets or capitalization of expenses. Revenue frauds accounted for over 60 percent of the cases, versus 50 percent in 1987-1997.
- Relatively few differences in board of director characteristics existed between firms engaging in fraud and similar firms not engaging in fraud. Also, in some instances, noted differences were in directions opposite of what might be expected. These results suggest the importance of research on governance processes and the interaction of various governance mechanisms.
- Twenty-six percent of the fraud firms changed auditors between the last clean financial statements and the last fraudulent financial statements, whereas only 12 percent of no-fraud firms switched auditors during that same time. Sixty percent of the fraud firms that changed auditors did so during the fraud period, while the remaining 40 percent changed in the fiscal period just before the fraud began.
- Initial news in the press of an alleged fraud resulted in an average 16.7 percent abnormal stock price decline in the two days surrounding the news announcement. In addition, news of an SEC or Department of Justice investigation resulted in an average 7.3 percent abnormal stock price decline.
- Long-term negative consequences of fraud were apparent. Companies engaged in fraud often experienced bankruptcy, delisting from a stock exchange, or material asset sales following discovery of fraud – at rates much higher than those experienced by no-fraud firms.

Given the small number of frauds examined in this study that involve time periods subsequent to the issuance of the Sarbanes-Oxley Act of 2002, further research will be needed once sufficient time has passed to allow for more observations of SEC fraud investigations involving post-SOX time periods before any conclusions can be reached about the effectiveness of that legislation in reducing instances of fraudulent financial reporting.

Our hope is that insights contained herein will encourage additional research to better understand organizational behaviors, leadership dynamics, and other important aspects of the financial reporting process that may have an impact on fraud prevention, deterrence, and detection.

We believe the results of this study will be useful to investors, regulators, stock exchanges, boards of directors, external auditors, and other key stakeholders as they seek to prevent, deter, and detect fraudulent financial reporting.

Content Outline

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I. Introduction, Key Findings, and Insights

Fraudulent financial reporting can have significant consequences for the organization and its stakeholders, as well as for public confidence in capital markets. Periodic high profile cases of fraudulent financial reporting raise concerns about the credibility of the U.S. financial reporting process and call into question the roles of management, auditors, regulators, and analysts, among others.

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) sponsored this research project to provide an extensive updated analysis of financial statement fraud occurrences affecting U.S. public companies. In the mid-1980s, the National Commission on Fraudulent Financial Reporting, sponsored by COSO, identified numerous causal factors believed to contribute to financial statement fraud (NCFFR 1987).[1] In addition, the COSO-sponsored study released in 1999, *Fraudulent Financial Reporting: 1987-1997, An Analysis of U.S. Public Companies*, provided a comprehensive analysis of fraudulent financial reporting through the late 1990s (Beasley et al. 1999).

Less is known about the profile of fraudulent financial reporting since 1997.[2] While the U.S. experienced an unprecedented spate of large company accounting frauds in 2001 and 2002, including those at Enron and WorldCom, it is unclear to what extent the typical fraud profile has changed in the past decade. Thus, COSO commissioned this research project to provide COSO, and others, with recent information that can be used to guide future efforts to combat the problem of financial statement fraud and to provide a better understanding of financial statement fraud cases.

This research has three specific objectives:

- To identify instances of alleged fraudulent financial reporting by registrants of the U.S. Securities and Exchange Commission (SEC) disclosed by the SEC in an Accounting and Auditing Enforcement Release (AAER) issued during the period 1998-2007.
- To examine certain key company and management characteristics for the companies involved in instances of financial statement fraud identified in AAERs and to compare certain fraud company characteristics to those of no-fraud control firms.
- To provide insights related to preventing, deterring, and detecting fraudulent financial reporting.

This study builds on the previous COSO-sponsored study, *Fraudulent Financial Reporting: 1987-1997*. Where possible, we use or adapt language from the prior report, and we compare key findings from this study to our findings in the 1999 study to highlight notable differences.

We analyzed instances of fraudulent financial reporting alleged by the SEC in AAERs issued during the ten-year period between January 1998 and December 2007. The AAERs, which contain summaries of enforcement actions by the SEC against public companies, represent one of the most comprehensive sources of alleged cases of financial statement fraud in the U.S. We focused on AAERs that involved an alleged violation of Rule 10(b)-5 of the 1934 Securities Exchange Act or Section 17(a) of the 1933 Securities Act given that these represent the primary antifraud provisions related to financial reporting for U.S. public companies. Our focus was on cases clearly involving financial statement fraud. We excluded from our analysis restatements of financial statements due to errors or earnings management activities that did not result in a violation of the federal antifraud statutes.

Our search identified 347 companies involved in alleged instances of fraudulent financial reporting during the ten-year period. These 347 alleged fraud instances are described in 1,335 individual AAERs (1,013 AAERs directly relate to fraud, while the other 322 describe non-fraud allegations related to the fraud companies). Findings reported in this study are based on information we obtained from our detailed analysis of (a) AAERs related to each of the sample fraud companies, (b) databases containing selected financial statement data reported in Form 10-Ks filed before and during the period the alleged financial statement fraud occurred, (c) proxy statements issued during the alleged fraud period, and (d) databases containing business press articles about the sample companies after the fraud was disclosed, as well as about the no-fraud control firms.

[1] We use the terms "fraudulent financial reporting" and "financial statement fraud" interchangeably throughout this document to represent the intentional material misstatement of financial statements or financial disclosures (in notes to the financial statements or Securities and Exchange Commission (SEC) filings) or the perpetration of an illegal act that has a material direct effect on the financial statements or financial disclosures.

[2] Others have studied aspects of fraudulent financial reporting since COSO's 1999 study was released. For example, see *Report Pursuant to Section 704 of the Sarbanes-Oxley Act* (SEC 2003), *Ten Things About Financial Statement Fraud – Second Edition* (Deloitte 2008a), *Ten Things About the Consequences of Financial Statement Fraud* (Deloitte 2008b), and *Ten Things About Financial Statement Fraud – Third Edition* (Deloitte 2009).

Key Findings and Insights

Several key findings and insights emerge from the detailed analysis of the 347 financial statement fraud cases. COSO hopes that close evaluation of these findings and insights will spawn ideas and further research that will help to strengthen the prevention, deterrence, and detection of fraudulent financial reporting.

Occurrences of Financial Statement Fraud

The vast majority of public companies appear to provide financial reports that are free from material misstatements due to fraud. However, financial statement fraud continued to exist during the 1998-2007 time frame, including the well-publicized frauds at Enron and WorldCom, among others. During the ten-year period 1998-2007, the SEC alleged fraud involving 347 companies as described in 1,335 AAERs. In comparison, the 1999 COSO study spanned 11 years of SEC fraud investigations in which nearly 300 frauds were described in nearly 700 AAERs. Despite thousands of publicly-traded companies filing apparently fairly stated financial statements over the ten-year period, the existence of fraud in any one of the 347 cases is significant to stakeholders of the affected entity. In addition, while the incidence of SEC fraud cases increased somewhat from 1987-1997 to 1998-2007, the magnitude of individual fraud cases increased markedly, as discussed below. Continued focus on finding ways to strengthen financial statement fraud prevention, deterrence, and detection is warranted.

Companies Involved

Fraud affects companies of all sizes. The companies committing fraud had median revenues and total assets just under $100 million in the period prior to the fraud. While the size of companies in this study was much larger than in COSO's 1999 study, which had median total assets of approximately $15 million, the range of assets or revenues for companies experiencing fraud was large. Fraud companies included startups with no assets or revenues, as well as companies with just under $400 billion in assets or over $100 billion in revenues. Thus, fraud is not limited to companies of a certain size.

Similarly, fraud occurred in a variety of industries. Consistent with COSO's 1999 study, the most frequent industries where fraud occurred included computer hardware and software (20 percent of the fraud companies) and other manufacturing (20 percent). These findings suggest that any actions to prevent, deter, or detect fraud should not be limited to any particular industry.

Most fraud companies' common stock (73 percent[3] of the sample) traded in over-the-counter markets and was not listed on the New York or American Stock Exchanges, similar to the frauds examined in COSO's 1999 study. Further study about differences in exchange listing requirements may provide insights as to whether certain requirements for registrants of the larger exchanges are relevant to the over-the-counter markets.

Financial Health of Companies Involved

Some companies committing fraud were experiencing net losses or were in close to break-even positions in periods before the fraud. The lowest quartile reflected companies in a net loss position and suffering from net operating cash flow shortages. Median company net income was $875,000, while median cash flow from operations was $317,000. Such closeness to break-even positions is consistent with results in COSO's 1999 study. Thus, pressures of financial strain or distress may have provided incentives for fraudulent activities for some fraud companies. Enhanced skepticism when companies are experiencing financial stress may be warranted for key governance participants, including the board of directors, auditors, and regulators.

Management's Tone at the Top

We gathered information about the types of individuals named by the SEC in the AAERs. The SEC continues to name senior management in AAERs for some level of involvement in the fraud, with the CEO and/or CFO named in almost all cases. These findings have important implications for the control environment.

Executives Named

In 72 percent of the cases, the AAERs named the CEO, and in 65 percent the AAERs named the CFO as being associated with the fraud. When considered together, in 89 percent of the cases, the AAERs named the CEO and/or CFO as being associated with the financial statement fraud. In COSO's 1999 study, the CEO and/or CFO were named in 83 percent of the cases. In addition, although the incidence of enforcement actions against the CEO was the same in the current study as in the 1999 study (72 percent of cases in

[3] Fifty percent of the firms were listed on NASDAQ, and 23 percent of the firms were traded on electronic bulletin boards, pink sheets, or via other over-the-counter markets.

each period), enforcement actions against the CFO were approximately 50 percent more likely in the current study (65 percent of cases, versus 43 percent in COSO's 1999 study).

More study is needed to determine if there are leading practices that help to reduce the risk of senior management involvement in financial statement fraud. For example, emerging practices may exist related to the screening and selection of senior executive officers, how they are compensated to avoid excessive fraud risks, and how boards and others oversee senior management. Mechanisms for sharing of those practices with wider audiences may need to be considered. In addition, CPA firms may want to focus additional effort on assessing the integrity of top management and sharing with the profession those approaches that prove effective.

Alleged Motivations

The SEC's most commonly cited motivations for fraud included the need to meet internal or external earnings expectations, an attempt to conceal the company's deteriorating financial condition, the need to increase the stock price, the need to bolster financial performance for pending equity or debt financing, or the desire to increase management compensation based on financial results.

Better understanding of the psyche of individuals who have engaged in fraud may provide insights as to factors that cause an individual to set aside his or her set of beliefs to engage in fraud. More can be learned about behavioral aspects that lead to attitudes and rationalizations that ultimately result in an individual or group of individuals deciding to engage in fraudulent financial reporting (see Ramamoorti 2008). Insights are needed as to factors that might lead an individual known to be of high integrity and to possess strong ethical values to subsequently justify committing a fraudulent act. Perhaps insights from prior research studies about leadership and other organizational behaviors in settings not involving fraud may have insights about possible motivators of fraudulent financial reporting. The academic community may be able to provide analyses or syntheses of findings and insights from prior organizational behavior research that would be helpful in identifying organizational behavior characteristics that may be associated with drivers of fraudulent financial reporting.

More guidance about how management's philosophy, integrity, and ethical culture interact with judgment and decision making is warranted. Insights about these interactions may serve to strengthen assessments of fraud risk conditions, especially those related to the attitudes and rationalizations of senior management in high fraud risk environments.

Nature of the Frauds

We gathered extensive information from the AAERs about the nature of the frauds, including the amounts involved, the fraud periods, and techniques used.

Size and Time Period of the Frauds

For the period 1998-2007, the total cumulative misstatement or misappropriation was nearly $120 billion across 300 fraud cases with available information (mean of nearly $400 million per case). This compares to a mean of $25 million of misstatement or misappropriation per sample fraud in COSO's 1999 study. While the largest frauds of the early 2000s skewed the 1998-2007 total and mean cumulative misstatement or misappropriation upward, the median fraud of $12.05 million in the present study also was nearly three times larger than the median fraud of $4.1 million in the 1999 COSO study. Thus, the magnitude of the fraud problem has increased in the past decade.

Most frauds were not isolated to a single fiscal period. The average fraud period extended 31.4 months, with the median fraud period extending 24 months. This was slightly longer than the average and median fraud periods of 23.7 and 21 months, respectively, reported in COSO's 1999 study. This finding suggests that once fraud is initiated in one financial period (quarterly or annual), management often continues to perpetrate fraud in each quarterly and annual financial statement filing for about two years.

Because there is a significant time lag between the occurrence of fraudulent financial reporting and the issuance of an AAER related to that fraud instance, most of the underlying instances of fraudulent financial reporting described in the AAERs examined in this study occurred before the passage of the Sarbanes-Oxley Act of 2002 (SOX). Only 61 of the 347 fraud companies examined in this study issued fraudulent financial statements involving periods subsequent to 2002, and only a small number of firms were subject to the provisions of Section 404 of SOX. Thus, future research is warranted to understand the impact of SOX on fraudulent financial reporting. It is premature to draw conclusions about the fraud detection impact of that legislation based on the frauds examined in this study. Furthermore, the approach used in this study does not allow us to provide any insights about the effect of SOX in preventing or deterring fraudulent financial reporting.

Fraud Techniques

The two most common techniques used to fraudulently misstate the financial statements involved improper revenue recognition and asset overstatements. The majority of frauds (61 percent) involved revenue recognition, while 51 percent involved overstated assets primarily by overvaluing existing assets or capitalizing expenses. The understatement of expenses and liabilities was much less frequent (31 percent). Misappropriation of assets occurred in 14 percent of the fraud cases, which was similar to the 12 percent reported in COSO's 1999 study.

The occurrence of improper revenue recognition (61 percent) was higher than the rate of occurrence (50 percent) reported in COSO's 1999 study. Close examination of revenue accounting and related fraud techniques is needed to better understand how revenue recognition is used to distort financial statement information. More detailed analysis of revenue fraud risk may be needed within industries to strengthen understanding of how revenue is fraudulently misstated. To the extent that improper revenue recognition involves non-financial executives, better education and training on revenue recognition concepts and SEC reporting obligations are needed.

Valuation issues related to recording existing assets deserve more focus, given that a majority of frauds involved asset overstatements. This concern may be heightened as financial reporting valuations become more dependent on fair value accounting.

Role of the Board of Directors

One of the major contributions of this study is the comparative analysis of board governance characteristics between fraud firms and a similar set of no-fraud firms. This allows us to observe whether certain board characteristics are more likely to be associated with fraud firms relative to no-fraud firms.

Full Board of Directors

The overarching insight from the analysis of differences in board characteristics between fraud and no-fraud firms is the lack of notable differences in many of the governance characteristics that have been the focus of regulators, exchanges, and governance experts in the last several years. For example, firms engaging in fraudulent financial reporting had more inside directors (i.e., management) than no-fraud firms during the sub-period 1991-1999.[4] However, following changes in stock exchange listing requirements implemented by the major U.S. exchanges, statistically significant differences in the composition of boards no longer existed between fraud and no-fraud firms in 2001-2004. Furthermore, while there are some differences in certain board characteristics between fraud and no-fraud firms that are statistically significant, in many instances the practical significance of those differences is not overwhelming.

Additional research and information-gathering about board processes may be needed to determine if there are certain board actions or tasks that impact fraud risk oversight, including board group dynamics, process flow, and board judgment and decision making (Beasley et al. 2009). Perhaps processes related to board agenda setting, the manner in which information is shared and discussed among the board members, and interactions between the board and management differ between fraud and no-fraud firms. More study is warranted.

Audit Committee

With all the focus on audit committees in the last decade, one of the important insights from this study is that meaningful differences in audit committee characteristics between fraud and no-fraud firms are generally no longer observed. For example, almost all fraud and no-fraud firms had audit committees; the average audit committee size for both groups was about three members; and on average, audit committees of both groups met nearly four times per year.

While many audit committee characteristics have been the focus of audit committee reform and regulation over the past decade, there is little evidence that these characteristics are associated with the occurrence of fraudulent financial reporting. Although we no longer see meaningful differences in most audit committee characteristics between fraud and no-fraud firms, this does not mean that all audit committees are similarly effective with respect to preventing, deterring, and detecting fraudulent financial reporting. Future research may be needed that focuses on the interaction of other governance mechanisms (e.g., the nominating committee) with the audit committee's ability to prevent, deter, and detect fraudulent financial reporting (see Carcello et al. 2010). And, future research about audit committee processes may be

[4] Our sample period overlapped the widely recognized *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees* (Blue Ribbon Committee (BRC) 1999). That report resulted in several changes in stock exchange listing requirements related to board governance made in 2000 by both the NYSE and NASDAQ. As a result, we partitioned our analysis of the data into two sub-periods, 1991-1999 and 2001-2004, based on the first fraud year. As explained later in this document, we excluded from this sub-analysis frauds occurring in the year 2000 because the stock exchanges made changes to their listing requirements in 2000.

needed to determine if other characteristics and behaviors of audit committees have an impact on the prevention, deterrence, or detection of fraudulent financial reporting.

Compensation Committee

Greater focus on the roles and processes used by compensation committees may provide helpful insights as to how boards consider the impact of compensation policies on the risk of fraud. Most fraud and no-fraud firms maintained a compensation committee, and there were few differences in compensation committee characteristics between fraud firms and no-fraud firms. Because compensation arrangements for senior executives are often tied to financial statement measures, more study about the effect of compensation policies and processes on fraud risk and board oversight of that risk may be needed.

Related Party Transactions

Fraud firms disclosed significantly more related party transactions than no-fraud firms. Seventy-nine percent of fraud firms had disclosed a related party transaction in the proxy statement filed during the first fraud period compared to 71 percent of no-fraud firms for the comparable time period. The higher frequency of related party transactions for fraud firms suggests that the presence of related party transactions may reflect heightened fraud risk. Greater scrutiny of related party transactions may be warranted to determine if the nature of those transactions has broader implications regarding management's integrity, philosophy, and ethical culture.

Auditor Considerations

Fraud goes undetected by auditors of all types and sizes. Big Six/Four firms audited 79 percent of the fraud companies during the fraud period (similar for the no-fraud firms at 83 percent). The challenges of detecting fraudulent misstatements of financial information affect auditors of entities spanning numerous industries and different sizes.

Type of Auditor Opinion on the Financial Statements

Virtually all of the fraud firms received an unqualified opinion on the last set of fraudulently misstated financial statements. However, the unqualified audit report of fraud firms was more likely (56 percent) to contain additional explanatory language than for no-fraud firms (36 percent). More research is needed to examine the nature of the audit report modification and to determine if there is any relation between the report modification and the nature of the fraud technique employed.

Section 404 of the Sarbanes-Oxley Act of 2002

Because of the significant time lag between the occurrence of fraud and the subsequent issuance by the SEC of an AAER, only a small number of the 347 instances of fraud affected accelerated filers subject to Section 404 of SOX. For those firms, the nature of the Section 404 internal control opinions did not foreshadow future financial reporting problems. The Section 404 opinions indicated effective internal controls unless there had already been a restatement or other correction of a 10-K announced. Therefore, adverse Section 404 opinions for the small sample examined were not diagnostic of future reporting problems, but instead only highlighted already-announced reporting problems.

The small sample size available for analysis limits our ability to draw any significant insights about auditors' ability to detect internal control weaknesses that may lead to fraud in the future. It also is important to note that we are unable to measure the impact of Section 404 in preventing or deterring management from engaging in fraudulent financial reporting.

Auditor Change and Auditor Implications

The rate of auditor changes for fraud firms was double the rate of auditor changes for the similar set of no-fraud firms. Twenty-six percent of the fraud firms versus 12 percent of the no-fraud firms changed auditors between the period that the company issued the last clean financial statements and the period the company issued the last set of fraudulent financial statements. Sixty percent of the auditor changes for fraud firms occurred during the fraud period, while the remaining 40 percent of fraud firms that changed auditors did so during the fiscal period just before the fraud began. A detailed hindsight analysis of auditor changes involving known instances of fraud may provide helpful insights about potential relations between conditions leading to auditor changes and conditions related to fraud occurrences.

Financial statement fraud sometimes implicated the external auditor. Auditors were named in the AAERs for 78 of the 342 fraud cases (23 percent) where AAERs named individuals. This was somewhat lower than what was reported (29 percent) in COSO's 1999 study. When auditors were named in the AAERs, about 39 percent of those named were charged with violating the anti-fraud statutes, while the remaining 61 percent were charged with violating non-fraud provisions including Rule 102(e) of the 1934 Securities Exchange Act. National audit firms were less likely to be named in an SEC enforcement action than were non-national firms, even though national firms audited most of the fraud companies.

Consequences for Individuals and Firms Engaged in Fraud

We gathered extensive data about consequences affecting both individuals serving in management roles and the companies as a whole for a period of two years subsequent to the issuance of the last AAER about the fraud. The pairing of fraud firms with no-fraud firms allowed us to analyze whether subsequent events affecting individuals and the company as a whole were significantly different for fraud firms relative to no-fraud firms.

Consequences for Individuals

The consequences associated with financial statement fraud were severe for individuals allegedly involved. In almost half of the cases (47 percent), the SEC barred one or more individuals from serving as an officer or director of a public company. Civil fines were imposed in 65 percent of the fraud cases, and disgorgements were imposed in 43 percent of the cases. The average fine imposed by the SEC was $12.4 million, and the average disgorgement was $18.1 million. The cumulative amount of fines for all fraud companies was $2.74 billion, while the cumulative amount of disgorgements was $2.65 billion. The median fine was $100,000, and the median disgorgement was $195,000.

Most CEOs and CFOs (80 percent or more) left the company within two years of the SEC's last AAER related to the fraud. Twenty-one percent of CEOs were indicted within that time period, and 64 percent of the indicted CEOs were convicted. Similarly, 17 percent of CFOs were indicted, with 75 percent of the indicted CFOs being convicted.

Despite the magnitude of these individual consequences, the severity of the penalties may not be a sufficient deterrent. More understanding about the mindset of fraud perpetrators may be needed to understand the factors individuals take into account when they engage in fraudulent activity. Better understanding of their perceptions about possible long-term consequences for engaging in fraud may provide useful perspectives about the deterrence effect of personal consequences.

Consequences for Companies Committing Fraud

Severe consequences also awaited companies committing fraud. Companies experienced significant abnormal stock price declines as news of the alleged frauds first emerged. The average fraud company's stock price dropped by an abnormal 16.7 percent in the two days surrounding the initial press disclosures of an alleged fraud. Fraud company stock prices also abnormally declined an average of 7.3 percent in the two days surrounding the announcement of a fraud investigation by the SEC or Department of Justice.

In addition to the negative stock market reactions to news announcements about alleged fraud or fraud investigations, many fraud firms suffered long-term consequences, including bankruptcy, delisting by national exchanges, and material asset sales. Twenty-eight percent of fraud firms were bankrupt or liquidated within two years from the year in which the SEC issued the last AAER related to the fraud, and 47 percent were delisted from a national stock exchange. Material asset sales also affected about 62 percent of fraud companies. These rates of occurrence were significantly higher than the experiences of no-fraud firms during those same time periods.

Conclusion

Detailed analyses of the findings described above are provided in the remainder of this report. We encourage parties involved in financial reporting to carefully consider the detailed information presented in this report. We also encourage further research to better understand many of the underlying factors likely to affect the prevention, deterrence, and detection of fraudulent financial reporting. COSO hopes numerous parties will recommit their efforts to improve the prevention, deterrence, and detection of fraudulent financial reporting.

Overview of Report

The remainder of this report is organized as follows. Section II provides a description of the approach we took to identify the cases of fraudulent financial reporting and contains a summary of the sources and methods used to gather data related to each case. Section III presents the results from our detailed analysis of the 347 cases of fraudulent financial reporting. Section IV provides concluding comments, and Section V contains a brief description of the authors who conducted this study.

We are confident that this report, *Fraudulent Financial Reporting: 1998-2007*, will prove helpful to parties concerned with corporate financial reporting and will add to the insights provided by COSO's 1999 study, *Fraudulent Financial Reporting: 1987-1997*. We hope the study will stimulate greater awareness of new opportunities for improvements in the corporate financial reporting process, as well as avenues for future research.

II. Description of Research Approach

This study builds on the previous COSO-sponsored study, *Fraudulent Financial Reporting: 1987-1997*, by presenting findings related to fraudulent financial reporting for the period 1998-2007. The data collection effort was conducted under the direction of four accounting researchers ("the authors") who oversaw the entire study including generation of this monograph. The authors worked with two research managers, who monitored and reviewed the work of a data collection team ("the team"). The research managers reported to and consulted with the authors throughout the entire research process.

The first step in this research project involved the identification of all alleged instances of fraudulent financial reporting captured by the SEC in an AAER issued during the period 1998-2007. In order to obtain detailed publicly-available information about company-wide and management characteristics of companies involved, the focus of this study was on instances of fraudulent financial reporting allegedly committed by SEC registrants that ultimately led to the issuance of an AAER.[5]

To identify instances of fraudulent financial reporting investigated by the SEC in the period 1998-2007, the team read all AAERs issued by the SEC between January 1998 and December 2007. From the reading, the team identified all AAERs that involved an alleged violation of Rule 10(b)-5 of the 1934 Securities Exchange Act or Section 17(a) of the 1933 Securities Act. We focused on violations of these securities laws given that these sections of the 1933 Securities Act and 1934 Securities Exchange Act are the primary antifraud provisions related to financial statement reporting. Because violations of these securities provisions generally require the intent to deceive, manipulate, or defraud, they more specifically indicate alleged instances of financial statement fraud than do other provisions of the securities laws.[6]

The AAERs represent one of the most comprehensive sources of alleged, discovered cases of financial statement fraud in the U.S. However, such an approach does limit the ability to generalize the results of this study to other settings. Because the identification of fraud cases was based on a review of AAERs, the findings are potentially biased by the enforcement strategies employed by the staff of the SEC. Because the SEC is faced with constrained resources, there is the possibility that not all cases of identified fraud occurring in the U.S. were addressed in the AAERs. There may be a heavier concentration of companies contained in the AAERs where the SEC assessed the probability of a successful finding of financial statement fraud as high. Also, the SEC may choose to conduct "sweeps" of particular industries or types of transactions, which may impact the distribution of fraud instances reported in AAERs. In addition, the cases contained in the AAERs represent instances where the SEC alleged the presence of financial statement fraud. In most instances, the company and/or individuals named neither admitted nor denied guilt. To the extent that enforcement biases are present, the results of this study are limited. However, given no better publicly-available source of alleged financial statement fraud instances, we believe that this approach was optimal under the circumstances. Furthermore, any SEC fraud investigation is a significant event in the life of the affected company and individuals involved in the financial reporting process, including boards of directors and auditors. Thus, insight as to fraud occurrences investigated by the SEC is informative, regardless of any inherent biases that may be present in how the SEC selects its enforcement cases.

For purposes of this report, the term "fraudulent financial reporting" represents the intentional material misstatement of financial statements or financial disclosures (in notes to the financial statements or SEC filings) or the perpetration of an illegal act that has a material direct effect on the financial statements or financial disclosures. The term financial statement fraud was distinguished from other causes of materially misleading financial statements, such as unintentional errors and other corporate improprieties that do not necessarily cause material inaccuracies in financial statements. Throughout this report, references to fraudulent financial reporting are all in the context of material misstatements. Our study excludes restatements of financial statements due to errors or earnings management activities that did not result in a violation of the federal antifraud securities provisions.

The team's reading of AAERs during this period allowed us to develop a comprehensive list of companies investigated by the SEC during 1998-2007 for alleged financial statement fraud. The team read 1,759 AAERs, beginning with AAER #1004 and ending with AAER #2762. From this process, we identified 347 companies (1,335 total AAERs for these 347 companies) involved in alleged instances of fraudulent financial reporting. For each of these companies, we accumulated information about the specific securities law violation to ensure that the case involved an alleged violation of Rule 10(b)-5 of the 1934 Securities Exchange Act or Section 17(a) of the 1933 Securities Act.

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[5] Publicly-traded partnerships, broker-dealers, and unit investment trusts were excluded from this study.

[6] We did not include other violations of laws whose only consequence gave rise to a potential contingent liability (e.g., an "indirect effect illegal act" such as a violation of Environmental Protection Agency regulations).

For each of the 347 companies, the team collected extensive information to create a comprehensive database of company and management characteristics surrounding instances of financial statement fraud from (a) AAERs related to the alleged fraud, (b) databases containing selected financial statement data reported in Form 10-Ks filed before and during the period the alleged financial statement fraud occurred, (c) proxy statements issued during the alleged fraud period, and (d) databases of business press articles written about the sample companies after the fraud was revealed, as well as about the no-fraud control firms.

SEC AAERs issued from 1998-2007 addressed 347 instances of fraudulent financial reporting.

Data Obtained from AAERs

The team read all AAERs issued during 1998-2007 related to the alleged financial statement fraud for each of the sample companies. In many cases, several AAERs related to a single fraud at one company. From the reading, the team attempted to capture the following information:

1. A list of the specific annual financial statements (contained in Form 10-Ks) or quarterly financial statements (contained in Form 10-Qs) fraudulently misstated and other filings with the SEC (e.g., S-1 registration statements) that incorporated fraudulently misstated financial statements. From this, we were able to determine the length of time the alleged fraud occurred.

2. A brief description of the nature of the fraud allegations including a description of how the fraud was allegedly perpetrated.

3. The dollar amounts of the fraud and the primary accounts affected.

4. Identification of types of personnel and outsiders involved in the fraud.

5. An indication of the alleged motivation for committing the fraud.

6. The industry in which the company operated.

7. A summary of the reported outcome of the SEC's investigation, including disciplinary action against senior management personnel.

Audited Financial Statement Data

We obtained selected audited financial statement data from annual financial statements filed in a Form 10-K with the SEC. We used Standard and Poor's COMPUSTAT® database to obtain selected balance sheet and income statement amounts from the audited financial statements included in the Form 10-K filed with the SEC for the fiscal period preceding the first known instance of fraudulently misstated financial statements for each of the sample companies ("last clean financial statements"). This provided us information about the financial position and results of operations in the period just before the period in which the fraud allegedly first occurred.

We also obtained from COMPUSTAT® the name of the audit firm responsible for auditing the financial statements issued during the fraud period and the nature of the auditor's opinion on those financial statements. If the fraud period extended more than one fiscal year, we obtained the name of the audit firm and the type of audit opinion issued for the last fiscal year of the fraud period.

Data Obtained from Proxy Statements

We obtained copies of the first proxy statement sent to shareholders during the period in which the alleged financial statement fraud was in process. We reviewed these proxy statements to gather information about the characteristics of the board of directors and its audit and compensation committees (composition, number of meetings, etc.) that were in place during the fraud period.

Data from Business Press Articles

To obtain information about consequences for the company, senior management, and board members subsequent to the revelation of the financial statement fraud, we performed an extensive search of the Factiva database of financial press articles. Among the many news sources included in Factiva are over 5,000 newspapers, journals, and magazines, including *The Wall Street Journal, The New York Times, The Financial Times,* and *The Economist,* and over 500 newswires including Dow Jones, Reuters, PR Newswire, and The Associated Press.

For each fraud, we performed a search for subsequent consequences to the company, senior management, and board members using a series of key word search strings. Our search began with the first day of the last fiscal year in which the fraud occurred, and ended on the last day of the fiscal year ending two fiscal years after the fiscal year in which the last AAER related to the fraud was issued.

We reviewed each instance where an article or press release was identified as a result of the application of key word search strings. We captured information about whether the company had experienced financial difficulty to the point of filing for bankruptcy, being placed in conservatorship, or liquidating. We also determined whether the company was delisted from a national stock exchange or a national securities association, or engaged in a material asset sale (including a sale of the company). We also captured information about the consequences of the alleged fraud for senior management and members of the board of directors, including resignation, termination, and other turnover. In addition, we captured whether members of senior management were criminally indicted and convicted. Finally, to examine abnormal stock price effects linked to public disclosures of the alleged fraud, we captured the first public disclosure that suggested that material accounting improprieties may have occurred, and the first public disclosure of an SEC or Department of Justice investigation.

Data Limitations

Readers should recognize that, despite the best efforts to collect complete data for all sample companies, the data sources used were often incomplete, and sometimes inconsistent. For example, AAERs were uneven in their level of disclosure, and other sources (e.g., Form 10-Ks, proxies, etc.) sometimes were not available. Additionally, the analysis is limited by the accuracy and completeness of information that is reported in these sources.

In addition to data availability issues, readers should also recognize that a great deal of professional judgment was necessary when collecting, categorizing, and synthesizing the data. Written summaries prepared from our analysis of the data obtained from the AAERs comprise several thousand pages of text, and the team incurred over 10,000 hours to gather and summarize the data underlying this study. We believe that we have been reasonable and consistent in our judgments, but the research approach was limited by the quality of our judgments.

Finally, the authors and research managers performed a great deal of data review to ensure the quality of the team's efforts. Much of the team's work was subjected to layers of reperformance, review, and reasonableness testing to promote sound and consistent data collection and summarization.

Given the various limitations above, we encourage readers to view the results as sound approximations of the underlying reality. With the large number of individuals on the team involved, and with the need for a large amount of professional judgment due to the nature of the underlying data, the results of the study should be viewed as providing a broad profile of fraudulent financial reporting during this period rather than perfectly precise dollar amounts or percentages for all data points included in this monograph.

III. Detailed Analysis of Instances of Fraudulent Financial Reporting: 1998-2007

We analyzed instances of fraudulent financial reporting reported by the SEC in AAERs issued between January 1998 and December 2007. After reading 1,759 AAERs, we identified 347 companies involved in alleged instances of fraudulent financial reporting.[7] In most instances, these fraud cases represent allegations of financial statement fraud made by the SEC without the company and/or individuals named in the AAER admitting guilt.

This section contains the findings from our reading of (a) AAERs related to each of the 347 companies, (b) databases containing selected financial statement data reported in Form 10-Ks filed before and during the period the alleged financial statement fraud occurred, (c) proxy statements issued during the alleged fraud period, and (d) databases of business press articles written about the sample companies after the fraud was disclosed. This section contains extensive information about each of the following items:

- Nature of the companies involved
- Characteristics of the alleged fraud perpetrators
- Nature of the frauds
- Board governance characteristics, including the nature of the audit committee and compensation committee
- Issues related to the external auditor
- Consequences to fraud companies and perpetrators subsequent to discovery.

To examine whether certain board governance characteristics and whether certain events affecting fraud firms subsequent to the revelation of a fraud event are unique to fraud companies, we gathered a sample of similar no-fraud firms to examine whether differences exist between fraud firms and no-fraud firms. Our methodology for selecting and evaluating information related to no-fraud firms is described later in this document in the section "Board Governance Characteristics."

Nature of Companies Involved

Financial Profile of Sample Companies

We were able to obtain the last clean financial statements for 313 of the 347 sample companies.[8] Table 1 highlights selected financial statement information for these fraud companies.

While total assets, total revenues, and stockholders' equity averaged $5.772 billion, $2.557 billion, and $1.001 billion, respectively, the median of total assets was $93.1 million, the median of total revenues was $72.4 million, and the median of stockholders' equity was $39.5 million in the period before the fraud began. Given third quartiles of total assets of $674 million, total revenues of $466 million, and stockholders' equity of $242 million, most of the sample companies operated under the $500 million size range.[9]

Fraud companies' median assets and revenues were just under $100 million in the year preceding the first fraud period.

Fraud affected companies of all sizes. Fraud companies ranged from startups with no assets or revenues to companies with just under $400 billion in assets or over $100 billion in revenues. Similarly, stockholders' equity ranged from negative equity of over $1 billion to positive equity of over $53 billion. However, the typical size of the fraud companies noted above is substantially larger than the fraud companies in COSO's 1999 study.

The sample companies in the 1999 study had total assets, total revenues, and stockholders' equity that averaged $533 million, $233 million, and $86 million, respectively. The median of total assets in the 1999 study was only $15.7 million, the median of total revenues was only $13 million, and the median of stockholders' equity was only $5 million in the period before the fraud began. Given third quartiles of total assets of $74 million, total revenues of $53 million, and stockholders' equity of $17 million, most of the sample fraud companies in the 1999 study operated well under the $100 million size range, which is substantially smaller than the sample fraud companies from the current study, even considering the effects of inflation.

7 Generally there were multiple Accounting and Auditing Enforcement Releases (AAERs) related to the fraud at a single company.

8 Our primary source of previously issued financial statements was the COMPUTSTAT® database. There were slight differences in availability of certain financial statement items. Thus, we were unable to locate each data item for all of the 313 sample companies available on COMPUTSTAT®, as shown in the last row of Table 1.

9 Because some high-profile frauds involving very large companies (e.g., Enron, WorldCom, etc.) are included in this ten-year period, the means are inflated. Therefore, we winsorized the sample by setting all observations above the 95th percentile to equal the value for the observation at the 95th percentile. The winsorized means were $1.9 billion for total assets, $1.6 billion for revenues, $478 million for stockholders' equity, $49 million for net income, and $84 million for cash flow from operations.

Some of the sample companies were financially stressed in the period preceding the fraud period. The median net income was only $875,000, with the 25th percentile facing net losses of nearly $2.1 million. The 75th percentile had net income just over $18 million in the year before the fraud allegedly began. Similarly, cash flow from operations averaged $246 million, while median cash flow from operations was only $317,000. This closeness to break-even positions was consistent with what was observed in COSO's 1999 study.

Table 1. Financial Profile of Sample Companies

Last Financial Statements Prior to Beginning of Fraud Period

	Total Assets	Revenues	Stockholders' Equity (Deficit)	Net Income (Loss)	Cash Flow From Operations
			(in $000s)		
Mean	$5,771,693	$2,557,298	$1,000,508	$140,097	$246,332
Median	$93,112	$72,360	$39,457	$875	$317
Minimum value	$0	($23)	($1,021,747)	($2,687,000)	($1,214,000)
1st quartile	$14,806	$9,468	$4,765	($2,136)	($2,007)
3rd quartile	$673,805	$465,870	$242,261	$18,090	$37,384
Maximum value	$391,673,000	$128,313,000	$53,206,590	$8,897,000	$16,654,000
Companies	313	311	312	311	303

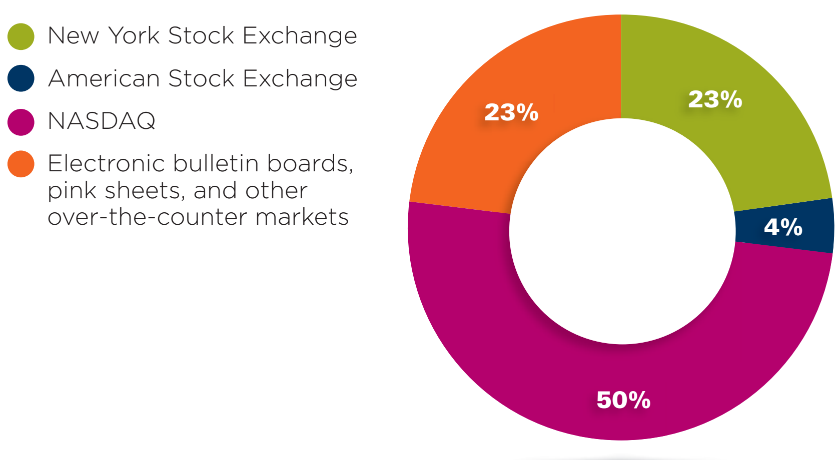
National Stock Exchange Listing

We reviewed the last clean financial statements and CRSP database to identify the national stock exchange where each company's stock traded. We were able to identify the stock exchange listing for 313 of the 347 sample companies. As indicated by the pie chart in Table 2, most (50 percent) were traded on the NASDAQ exchange. Twenty-three percent of the companies' stock traded on the New York Stock Exchange, and four percent of the companies' stock traded on the American Stock Exchange. Finally, 23 percent of the companies' stock traded on electronic bulletin boards, pink sheets, and other over-the-counter markets.

According to the *2006 Final Report of the Advisory Committee on Smaller Public Companies* (Advisory Committee 2006), approximately 19.5 percent of all publicly-traded companies are registered on the New York Stock Exchange, 5.7 percent are registered on the American Stock Exchange, and 24.2 percent trade in the NASDAQ National Market or NASDAQ Capital Market. The remainder trade on the over-the-counter bulletin boards (22.6 percent) or pink sheets (28.0 percent). Thus, the mix of fraud firms trading in NASDAQ markets (50 percent) is higher than the overall profile of public companies on NASDAQ (24 percent).

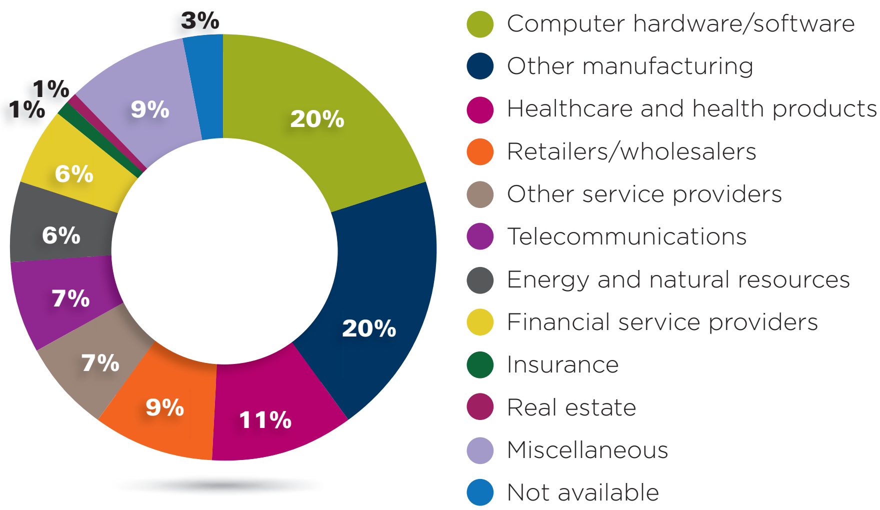
Table 2. Sample Companies' National Stock Exchange Listing

(n = 313 with Available Information)



The percentage of companies (73 percent) whose stock traded on any over-the-counter market (NASDAQ, electronic bulletin boards, pink sheets, etc.) was in line with the 78 percent of companies in the 1999 COSO study whose stock traded on any of the over-the-counter markets. The percentage of companies in COSO's 1999 study whose stock traded on the New York Stock Exchange (15 percent) or American Stock Exchange (7 percent) also was fairly similar to the present study.

Table 3. Primary Industries of Sample Fraud Companies



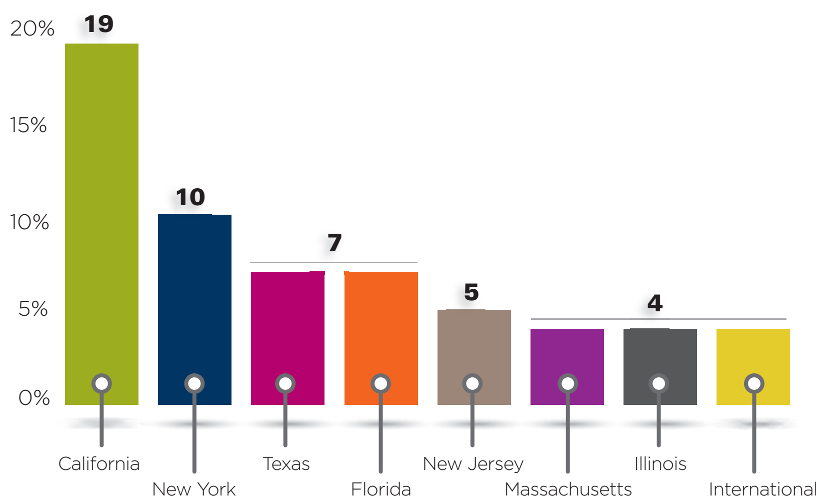
Industries for Companies Involved

We reviewed the information included in the AAERs to determine the primary industry in which the fraud companies operated. Similar to our findings in the 1999 COSO study, the two most frequent industries cited were computer hardware and software (20 percent) and other manufacturing (20 percent). Other frequently-cited industries in the current study were healthcare/health products (11 percent), retailers/wholesalers (9 percent), other service providers (7 percent), and telecommunications (7 percent). See the pie chart in Table 3.

Geographic Location of Sample Companies

We reviewed the AAERs to identify the geographic location of the fraud companies. Most of the frauds were committed at or directed from the companies' headquarters locations. We were able to identify the headquarters location for 329 of the 347 fraud companies. Table 4 contains information about the frequency of cases for states in which at least 10 fraud companies were located. Similar to sample fraud companies examined in COSO's 1999 study, the highest percentages of frauds involved companies headquartered in California and New York. In the current study, the most fraud companies were located in California (19 percent of the fraud cases), New York (10 percent), Texas (7 percent), Florida (7 percent), New Jersey (5 percent), Massachusetts (4 percent), and Illinois (4 percent). This pattern is consistent with centers of business activity in the U.S.

Table 4. Locations of Fraud Companies' Headquarters
(n = 329 with available information)



Alleged Fraud Perpetrators

Individuals Named in the AAERs

From our reading of the AAERs, we captured information about the types of company representatives and outsiders named in an AAER related to each instance of alleged fraudulent financial reporting. We captured names of all individuals listed in any of the AAERs related to an instance of fraudulent financial reporting, whether these individuals were charged with fraud or charged with other lesser violations. The SEC named in the AAERs individuals involved in the alleged fraud for 342 of the 347 fraud companies. Even though these individuals were named in an AAER, there was no certain evidence that all the named participants violated the antifraud statutes, and other individuals not named in an AAER may have been involved in the fraud. In addition, most of the named participants neither admitted nor denied guilt of any kind.

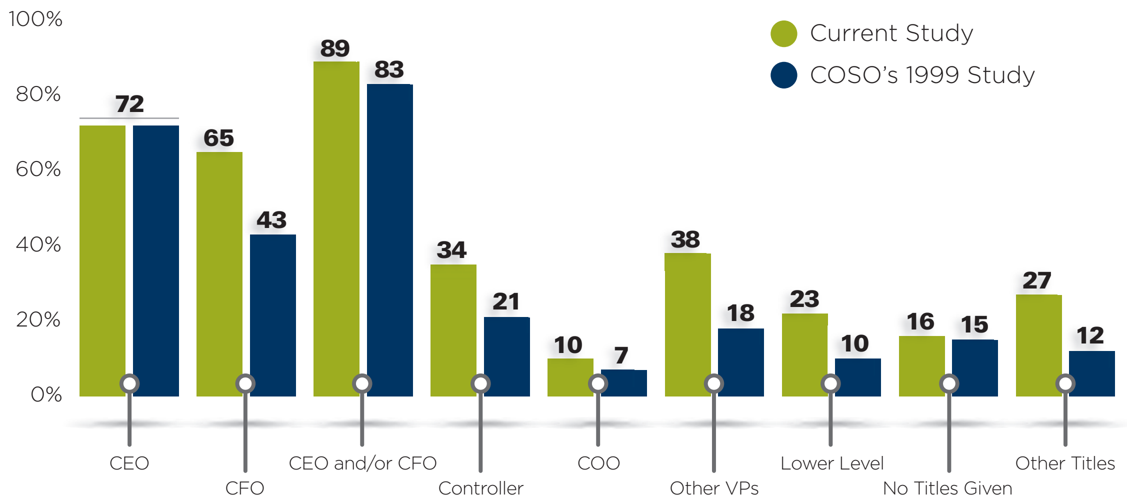
Using the highest managerial title for an individual, we summarized the typical employee positions named in the AAER. For example, if one individual had the titles of chief financial officer (CFO) and controller, we reported that as involving strictly the CFO position in our reporting in Table 5 on the next page. As noted in Table 5, the senior executive most frequently named in an AAER was the chief executive officer (CEO). The CEO was named as one of the parties involved in 246 of 342 fraud companies, representing 72 percent of the sample companies with available information. The second most frequently identified senior executive was the CFO. The CFO was named in 222 of the 342 fraud companies, which represents 65 percent of the companies involved. When considered together, the CEO and/or CFO were named in 305 of the 342 cases (89 percent).

The CEO and/or CFO were named in an AAER for 89% of the fraud companies.

The company controller was named in 115 of the 342 frauds, representing 34 percent of the fraud instances. The chief operating officer (COO) was named in 10 percent of the frauds (35 of 342), and other vice presidents were named in 129 of the 342 frauds (38 percent of the cases). Lower level personnel were named in 23 percent of the cases (80 of 342 fraud instances). Recall that our classification scheme tracked the highest named position for an individual. Thus, the noted percentages associated with less senior positions may be understated. In addition, because of the relatively small size of some of the fraud firms in this sample, some of the noted positions (e.g., COO) may not have been filled. Finally, SEC enforcement actions may target top executives more frequently than lower level employees. These factors may contribute to the lower percentages noted for these positions.

The frequency with which the AAERs name the CEO as being allegedly involved in the fraud was the same (72 percent of fraud companies) for the current study and the 1999 COSO study. However, the frequency with which the AAERs named

Table 5. Types and Frequencies of Individuals Named in AAERs



Note: In many cases the AAERs cited board members for their involvement in the fraud. The vast majority of these individuals appeared to be company managers serving on the board, including CEOs serving as Board Chair.

the CEO and/or CFO in the current study (89 percent) is slightly higher than in the 1999 COSO study (83 percent). In addition, the CFO was approximately 50 percent more likely to be subject to an SEC enforcement action in the current study than in the 1999 study (named in 65 percent of cases in the current study, versus 43 percent of cases in COSO's 1999 study). Finally, the frequency with which the SEC named other individuals in the AAERs was generally higher in the current study as compared to the 1999 COSO study.

In addition to the results in Table 5, individuals named in the AAERs extended beyond company executives. In 81 of the 342 fraud companies (24 percent of the cases), outsiders were named, generally customers and vendors. The external auditor was named in the AAER for 78 of the 342 fraud companies (23 percent of the fraud cases with information about perpetrators), and members of the audit committee were named in 7 of the 342 fraud companies (2 percent of the cases).

Alleged Motivation for the Fraud

In some instances, the SEC provided discussion in the AAERs about the alleged motivation for the fraud. Because the SEC did not consistently describe the alleged motivations in each fraud instance and there were often multiple motivations for a single fraud, we do not provide summary statistics about the rate of particular motivations. However, among those noted, the most commonly cited reasons summarized by the SEC in the AAERs include committing the fraud to –

- Meet external earnings expectations of analysts and others
- Meet internally set financial targets or make the company look better
- Conceal the company's deteriorating financial condition
- Increase the stock price
- Bolster financial position for pending equity or debt financing
- Increase management compensation through achievement of bonus targets and through enhanced stock appreciation
- Cover up assets misappropriated for personal gain.

Nature of the Frauds

Total Amount of the Fraud

In an attempt to obtain a judgmental measure of the typical size of the financial statement frauds, we accumulated information from the AAERs that provided some indication of the amounts involved. In some cases, the AAERs did not disclose the dollar amounts involved. As a result, we were only able to obtain some measure of the dollar amounts involved for 300 of the 347 fraud companies. As reported in Table 6, the average fraud involved $397.68 million of cumulative misstatement or misappropriation over the fraud period, while the median fraud involved $12.05 million.[10] The smallest fraud was $47,200, while the largest totaled $25.8 billion.[11] The first and third quartiles of cumulative misstatements or misappropriations were $3.65 million and $55.95 million, respectively.[12] The wide variance between the mean and median fraud amounts is due to a few large high-profile frauds during the period, such as the frauds at Enron and WorldCom.

The average cumulative misstatement amount was $397.68 million, while the median cumulative misstatement was $12.05 million.

Table 6. Cumulative Dollar Amount of Fraud for a Single Company

	# of Sample Companies with Information	Mean Cumulative Misstatement or Misappropriation *(in $ millions)*	Median Cumulative Misstatement or Misappropriation *(in $ millions)*
Cumulative amount of fraud for a single company	300	$397.68	$12.05
Minimum = $47,200; Maximum = $25.8 billion; 1st quartile = $3.65 million; 3rd quartile = $55.95 million			

The size of the cumulative misstatement or misappropriation in the current study was substantially larger than the cumulative misstatement or misappropriation summarized in COSO's 1999 study. For the sample fraud companies in the 1999 COSO study, the average cumulative misstatement was only $25.0 million, while the median cumulative misstatement was $4.1 million. The first and third quartiles of cumulative misstatements or misappropriations for the 1999 COSO study were $1.6 million and $11.76 million, respectively.

For the period 1998-2007, the total cumulative misstatement or misappropriation was nearly $120 billion across 300 fraud cases with available information. This large total is driven by the numerous large company frauds of the early 2000s, including Enron, WorldCom, and others. It is clear that the magnitude of the fraud cases was much greater in 1998-2007 than in 1987-1997.

Unfortunately, the AAERs do not consistently report the dollar amounts involved in each fraud. In some instances, the AAERs report the dollar amounts of the fraud by noting the extent to which assets were misstated. In other cases, the AAERs report the amounts that revenues, net income, pre-tax income, or other items were misstated. We used the nature of the data presented in the AAER to develop a reasonable measure of the fraud amount; however, we caution the reader that a great deal of judgment was used. In addition, this analysis was dependent on which figures the SEC chose to disclose in the AAERs. Accordingly, the categories and figures below should be viewed as reasonable estimates of fraud amounts (i.e., not exact point estimates). Information about the amounts involved by fraud type is provided on the next page in Table 7.

[10] To evaluate the impact of large outliers, we winsorized the data by setting the cumulative misstatement or misappropriation amount for those frauds above the 95th percentile to be equal to the value for the 95th percentile. The winsorized average was $203.7 million.

[11] For two high-profile frauds, Royal Ahold and WorldCom, the cumulative fraud amounts provided in the AAERs were somewhat lower than amounts we noticed in either an SEC press release or in media descriptions of the case. For consistency, in Table 6 we always used the amounts presented in the AAERs, rather than including any larger fraud amounts discussed in press releases or media stories.

[12] Ideally, we would report misstatement information in percentage rather than dollar terms. However, we are unable to report percentages for most companies due to the limited amount of information provided in the AAERs about dollar misstatements and the lack of available financial statements for all fraud periods (which reflect misstated values anyway) for those companies with AAERs reporting misstatement information.

Asset misstatements averaged $226.74 million, with a median of $7.9 million. The average misstatements of revenues, expenses, pre-tax income, and net income ranged from $91.44 million to $958.98 million, with medians ranging from $10.2 million to $21.5 million. The average misappropriation of assets (i.e., theft of assets) was $16.3 million, while the median misappropriation of assets was $4.0 million.

Table 7. Dollar Amount of Misstatements by Fraud Type

Misstatement Type	# of Fraud Companies with Information	Mean Cumulative Misstatement *(in $ millions)*	Median Cumulative Misstatement *(in $ millions)*
Assets	44	$226.74	$7.9
Revenue or gain	132	$455.04	$10.3
Expense	26	$91.44	$19.8
Pre-tax income	20	$958.98	$21.5
Net income	36	$525.21	$10.2
Misappropriation of assets	15	$16.30	$4.0

Note: See Table 1 for the typical size of the companies involved.

While Tables 6 and 7 provide some information about the average and median cumulative effects of the fraud over the entire fraud period, Table 8 provides an overview of the largest income misstatement in a single period. For each of the companies where the related AAERs reported misstatement information as a function of pre-tax income or net income, we identified the largest single-year or single-quarter misstatement over that company's fraud period. For the AAERs providing misstatement information relative to pre-tax income (information provided for 66 companies), the average of the largest pre-tax misstatement in a single period was $101.6 million, with a median single period pre-tax misstatement of $6.75 million. This was substantially larger than in COSO's 1999 study, which reported an average pre-tax income misstatement of $7.1 million and median pre-tax income misstatement of $3.2 million. For AAERs reporting misstatements as a function of net income (105 companies), the average largest single period misstatement of net income was $90.4 million with a median single period net income misstatement of $5.0 million.[13] This was also substantially larger than the average and median largest single period net income misstatement of $9.9 million and $2.2 million, respectively, reported in COSO's 1999 study.

Table 8. Largest Single Period Income Misstatement

Description	# of Fraud Companies with Information	Mean Largest Single Year or Quarter Misstatement *(in $ millions)*	Median Largest Single Year or Quarter Misstatement *(in $ millions)*
Information reported as a function of pre-tax income	66	$101.6	$6.75
Information reported as a function of net income	105	$90.4	$5.0

Timing of Fraud Period

For the 347 instances of fraudulent financial reporting, the related fraudulently misstated financial statements were issued in calendar years beginning before 1990 and extending through 2006. The years with the greatest number of misstatements were 1997-2001, with over 100 companies misstating their financials in each of these years. Due to the time lag in SEC enforcement, the vast majority of the misstated periods were before the passage of SOX in 2002.

[13] The winsorized means (set equal to the 95th percentile value) were $54.3 million for pre-tax income and $38.0 million for net income.

Only 61 of the 347 fraud companies examined in this study had fraudulently misstated financial statements involving periods subsequent to 2002. Only a small number of those involved companies subject to the reporting provisions of Section 404 of SOX.

Typical Length of Problem Period

The financial statement frauds generally involved multiple fiscal periods. Information to determine the number of months from the beginning of the first fraud period to the end of the last fraud period was available for all of the 347 sample companies. Fraud periods extended on average for 31.4 months, with the median fraud period extending 24 months. This was slightly longer than the average and median fraud periods of 23.7 months and 21 months, respectively, reported in COSO's 1999 study. Many of the frauds began with misstatements of interim financial statements that were continued in annual financial statement filings. Only 44 of the 347 companies (13 percent) issued fraudulent financial statements involving a period of less than twelve months. The longest problem period was 180 months (and it was 168 months for two other companies).

The typical length of the fraud period was 2 years.

Methods of Fraudulently Reporting Financial Statement Information

Based upon information included in the AAERs, we made our best attempt to identify the methods used to fraudulently report the financial statement information. As noted in Table 9, the two most common techniques used to fraudulently misstate financial statement information involved overstating revenues and assets. Sixty-one percent of the 347 fraud companies recorded revenues inappropriately, primarily by creating fictitious revenue transactions or by recording revenues prematurely. This was a higher rate of revenue misstatements than the 50 percent found in COSO's 1999 study.

Fifty-one percent of the 347 fraud companies overstated assets, primarily by overvaluing existing assets or capitalizing items that should have been expensed.[14] Thirty-one percent of the 347 companies' financial statements were misstated through the understatement of expenses/liabilities. That rate was higher than the 18 percent found in COSO's 1999 study.

Fraudulent misstatement of financial statements frequently involved the overstatement of revenues and assets. Intentional misstatement of financial statements was noted much more frequently than misappropriation of assets.

Table 9. Common Financial Statement Fraud Techniques

Methods Used to Misstate Financial Statements	Percentage of the 347 Fraud Companies Using Fraud Method [a]
Improper revenue recognition:	61%
Recording fictitious revenues – 48%	
Recording revenues prematurely – 35%	
No description/"overstated" – 2%	
Overstatement of assets (excluding accounts receivable overstatements due to revenue fraud):	51%
Overstating existing assets or capitalizing expenses – 46%	
Recording fictitious assets or assets not owned – 11%	
Understatement of expenses/liabilities	31%
Misappropriation of assets	14%
Inappropriate disclosure (with no financial statement line item effects)	1%
Other miscellaneous techniques (acquisitions, joint ventures, netting of amounts, etc.)	20%
Disguised through use of related party transactions	18%
Insider trading also cited	24%

[a] *The subcategories such as premature revenues or fictitious revenues and assets do not sum to the category totals due to multiple types of fraud employed at a single company. Also, because the financial statement frauds at the sample companies often involved more than one fraud technique, the sum of the percentages reported exceeds 100 percent.*

[14] To avoid double-counting, the information about the overstatement of assets does not include overstatements of accounts receivable due to the revenue recognition frauds.

Most of the financial statement fraud instances involved intentionally misstating financial statement information, with only 14 percent of the fraud cases involving misappropriation of company assets (i.e., theft of assets). This was consistent with earlier findings in COSO's 1999 study that 12 percent of the fraud cases involved misappropriation of assets and in the 1987 *Report of the National Commission on Fraudulent Financial Reporting* that 13 percent of the cases against public companies involved misappropriation of assets.

As noted in Table 9, over 60 percent of the sample companies overstated revenues. The revenue misstatements were primarily due to recording revenues fictitiously or prematurely by employing a variety of techniques that include the following:

- **Sham sales.** To conceal the fraud, company representatives often falsified inventory records, shipping records, and invoices. In some cases, the company recorded sales for goods merely shipped to another company location. In other cases, the company pretended to ship goods to appear as if a sale occurred and then hid the related inventory, which was never shipped to customers, from company auditors.
- **Conditional sales**. These transactions were recorded as revenues even though the sales involved unresolved contingencies or the terms of the sale were amended subsequently by side letter agreements, which often eliminated the customer's obligation to keep the merchandise.
- **Round-tripping or recording loans as sales**. Some companies recorded sales by shipping goods to alleged customers and then providing funds to the customers to pay back to the company. In other cases, companies recorded loan proceeds as revenues.
- **Bill and hold transactions.** Several companies improperly recorded sales from bill and hold transactions that did not meet the criteria for revenue recognition.
- **Premature revenues before all the terms of the sale were completed**. Generally this involved recording sales after the goods were ordered but before they were shipped to the customer.
- **Improper cutoff of sales**. To increase revenues, the accounting records were held open beyond the balance sheet date to record sales of the subsequent accounting period in the current period.
- **Improper use of the percentage of completion method**. Revenues were overstated by accelerating the estimated percentage of completion for projects in process.
- **Unauthorized shipments**. Revenues were overstated by shipping goods never ordered by the customer or by shipping defective products and recording revenues at full, rather than discounted, prices.
- **Consignment sales**. Revenues were recorded for consignment shipments or shipments of goods for customers to consider on a trial basis.

We do not report percentages for each of the above types of fraudulent revenue schemes because the language used by the SEC to describe fraud techniques varied extensively, making it difficult to classify the various types in exact ways. Thus, it was difficult to categorize reliably the frequency of a specific revenue recognition fraud technique.[15]

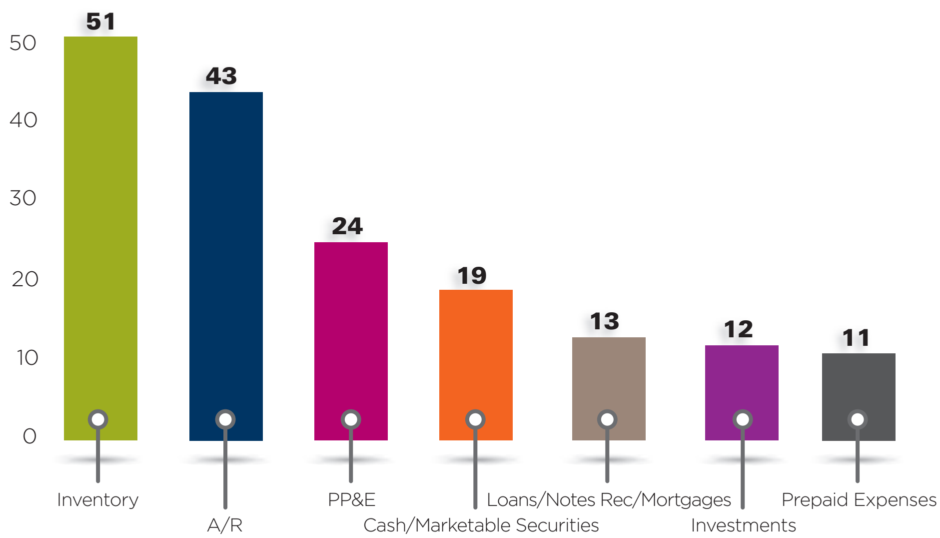
Also, in several instances, company representatives were able to falsify confirmation responses directly or indirectly by convincing third parties to alter the confirmation response. In other cases, company personnel created a variety of false documents.

Over half of the sample companies misstated the financial statement information by overstating assets. Table 10 highlights the typical asset accounts overstated by sample companies. Even excluding the effects of misstating accounts receivable due to the revenue recognition frauds, the two most common asset accounts misstated were inventory (51 cases) and accounts receivable (43 cases). Other asset accounts misstated included property, plant, and equipment (24 cases); cash/marketable securities (19 cases); loans/notes receivable/mortgages (13 cases); investments (12 cases); and prepaid expenses (11 cases).

[15] There are many rich examples of alleged revenue frauds using the methods listed above. Interested readers may consult the following AAERs for illustrative examples of many of these methods. These AAERs were haphazardly selected from numerous possible examples, and there is no intent to highlight any particular company or individual. Rather, these AAERs simply provide interesting insights into alleged revenue fraud methods.

- AAER 1422 - www.sec.gov/litigation/admin/33-7994.htm
- AAER 1559 - www.sec.gov/litigation/litreleases/lr17522.htm
- AAER 2200 - www.sec.gov/litigation/litreleases/lr19121.htm and related complaint at www.sec.gov/litigation/complaints/comp19121.pdf
- AAER 2126 - www.sec.gov/litigation/litreleases/lr18935.htm and related complaint at www.sec.gov/litigation/complaints/comp18935.pdf
- AAER 2451 - www.sec.gov/litigation/admin/2006/33-8716.pdf

Table 10. Number of Fraud Cases With Asset Accounts Misstated



Board Governance Characteristics

A large body of accounting research examines the relation between board governance characteristics and accounting outcomes (for example, see Cohen et al. 2004; DeZoort et al. 2002). To contribute to our understanding of the relation between the presence of fraud and board governance characteristics, we gathered information on the board of directors and on the audit and compensation committees from company proxy statements filed with the SEC. Because we were interested in the governance characteristics in place at the time the fraud began, we gathered governance data based on who was on the board and on the board committees during the first fraud year by examining the proxy statements filed with the SEC in the first year of the fraud. We were able to locate proxies for 203 of the 347 fraud companies.[16] We also gathered data on board leadership issues disclosed by the company in the proxy statement (e.g., whether the same individual served as both CEO and chairman of the board, whether the company's founder was on the board, etc.) and whether there were disclosures of related party transactions.

To analyze whether certain governance characteristics were associated with a higher incidence of fraud, we gathered a sample of 203 no-fraud companies that is similar to the 203 fraud companies with available proxy information. Our goal was to compare the board governance characteristics of the fraud companies with similar companies apparently not engaging in fraud to identify whether certain board governance characteristics differed between fraud and no-fraud firms.

For each fraud company, we selected a similar no-fraud company. First, the fraud and no-fraud pairs are traded on the same stock exchange. For example, if the fraud company was traded on NASDAQ, the no-fraud company was selected from NASDAQ to control for differences in governance characteristics across exchanges. Second, the proxy data are gathered from corresponding time periods (i.e., to control for differences in governance characteristics across time). Third, the industries of the fraud and no-fraud samples are similar (based on the Standard Industrial Classification (SIC) codes), so as to control for any variations in governance characteristics across industries.

Finally, after the first three constraints, we attempted to make the size of the fraud and no-fraud companies as similar as possible, since larger companies are expected to have more advanced governance mechanisms due to their greater resources. Achieving similar size was the most challenging, as the other three constraints were already in place. If we could not identify an appropriate no-fraud firm whose market value of equity was within plus or minus 30 percent of the fraud firm's market value, we then measured size using total assets (plus or minus 30 percent). Ultimately, the size of the fraud and no-fraud companies is within plus or minus 30 percent in over 75 percent of the cases. There are no significant differences in median market value of equity or assets between fraud and no-fraud firms. Based on

[16] In some instances, the companies failed to file a proxy with the SEC. For others, the relevant proxy was not available in electronic databases or via purchase through outside vendors.

the procedures described above, the samples of fraud and no-fraud companies are similar and provide a reasonable basis for comparison.

Our sample period overlapped the widely recognized *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees* (BRC 1999), jointly issued in 1999 by the New York Stock Exchange and the National Association of Securities Dealers. That report resulted in several changes in stock exchange listing requirements related to board governance implemented in 2000 by both the NYSE and NASDAQ. As a result, we partitioned our analysis of the data into two sub-periods, 1991-1999 and 2001-2004, based on the first fraud year for these 203 fraud companies.[17] This allowed us to examine whether linkages between certain board governance characteristics and fraud occurrences continued subsequent to several changes in listing requirements related to board governance.

The overarching insight from the analysis of differences in board characteristics between fraud and no-fraud firms reported in the pages that follow is the lack of notable statistical differences in many of the governance characteristics that have been the focus of regulators, exchanges, and governance experts in the last several years. Many board of director characteristics appear to no longer differ significantly between fraud and no-fraud firms. And, in some instances, the noted differences are in directions opposite of what might be expected. Furthermore, while some characteristics were found to be statistically significant, many of those differences may lack any practical significance (i.e., they may be too small to matter). While we report whether there are statistical differences between fraud and no-fraud firm governance characteristics, we leave the evaluation of practical significance to the reader.

These collective observations raise the possibility that there are other more important governance characteristics or processes that affect the board's ability to assess the risk of financial statement fraud and oversee the implementation of procedures to prevent, deter, and detect fraud.

Full Board of Director Characteristics

Board Size and Independence

Table 11 contains information about the size and composition of the full board of directors. For each board characteristic in Table 11, we report the average for the fraud firms and the average for the similar set of no-fraud firms for the full sample and for each of the sub-periods examined (1991-1999 and 2001-2004). We also report the difference in averages between the fraud and no-fraud firms and report the results of our statistical tests by providing the p-value results when those differences between fraud and no-fraud firms were statistically significant.[18] We conducted tests to determine whether the differences between fraud and no-fraud firms were statistically significant for both the full sample and the two sub-periods examined. Because the sample sizes for each of the sub-periods examined were much smaller than the full sample (especially for the 2001-2004 sub-period), the lack of statistical significance in tests of each sub-period may be due to lack of statistical power due to the smaller sample sizes. Thus, there may be differences in fraud and no-fraud firms that we cannot statistically observe due to size limitations in each sub-sample.

For all board characteristics where we report a p-value less than 0.10, the differences between fraud and no-fraud firms were interpreted to be statistically significant, consistent with most research. If no p-value is reported for a particular board characteristic, readers should conclude that fraud and no-fraud firms do not differ significantly in that board characteristic. We use this reporting technique for all tables where we report a statistical test of the difference between fraud and no-fraud firms.

As shown in Table 11, the average fraud firm had 7.7 directors on the board as compared to 8.0 directors for no-fraud firms. This difference was not statistically significant.

A large body of academic research finds that board and audit committee independence affects the effectiveness of board and audit committee oversight. We examined the relation between board independence and fraud. In analyzing board member independence, the following

17 While we studied AAERs issued by the SEC between 1998 and 2007, the calendar years in which these 203 frauds began were as early as 1991 and as late as 2004. In our sub-period analyses, we excluded frauds occurring in 2000 because the BRC Report was issued in 1999 and the stock exchanges made changes to their listing standards in 2000. Interestingly, though, more frauds began in 2000 (n = 38) than in any other year. Thus, we re-ran our analyses including the year 2000 in the post sub-period (i.e., we compared the 1991-1999 sub-period to the 2000-2004 sub-period as a sensitivity test). Our results were very similar to those reported in this monograph.

18 We tested whether there was a statistical difference between the fraud sample and the no-fraud sample for each variable. We report p-values for those differences that were statistically significant at below the 0.10 level (two-tailed).

definitions were used to categorize individual members of the board of directors into one of three categories:

- **Inside director** – A director who was also an officer or employee of the company or a subsidiary or an officer of an affiliated company.
- **Grey director** – A director who was a former officer or employee of the company, a subsidiary, or an affiliate; relative of management; professional advisor to the company; officer or owner of a significant supplier or customer of the company; interlocking director; officer or employee of another company controlled by the CEO or the company's majority owner; owner of an affiliate company; or creditor of the company.
- **Outside director** – A director who had no disclosed relationship (other than stock ownership) between the director and the company or its officers.

The average percentage of inside directors on the board for fraud firms was 30 percent as compared to 25 percent for no-fraud firms. This difference was statistically significant (p-value = 0.010). There was no significant difference in the percentage of outside directors for fraud firms (60 percent of the board) versus no-fraud firms (63 percent of the board).

There was no statistical difference between the two groups in the average percentage of grey directors. We were able to analyze the types of grey directors serving on the board of directors for 63 fraud and 63 no-fraud firms. The most common types of grey directors were former company officers, consultants, and outside legal counsel. Differences in types of grey directors serving on fraud and no-fraud firms were not statistically significant, except for the difference in the percentage of grey directors who were relatives of management. Seven percent of fraud firm grey directors were relatives of management as compared to 18 percent for no-fraud firms (p-value = 0.086).

When board independence was examined for the two sub-periods (1991-1999 and 2001-2004), we found that the results for the 1991-1999 sub-period were generally consistent with the full sample results. That is, fraud firms had statistically more inside directors than no-fraud firms for 1991-1999 (p-value = 0.069). We also found that fraud firms were significantly more likely to have consultants as grey directors (32 percent) than were no-fraud firms (14 percent) (p-value = 0.034). However, the types of directors serving on boards in 2001-2004 were not statistically different for fraud and no-fraud firms. Thus, differences in board composition following the year 2000 may no longer be associated with the occurrence of fraudulent financial reporting.

We found a decrease in the percentage of inside and grey directors on boards between the two sub-periods for both fraud and no-fraud firms. For 1991-1999, 32 percent of the fraud firm boards were composed of inside directors as compared to only 25 percent of the fraud firm boards in 2001-2004. Consistent with that trend, the percentage of outside directors on fraud firm boards increased from 56 percent in the 1991-1999 sub-period to 67 percent in the 2001-2004 sub-period. This was consistent with a general shift in governance expectations over time that boards should have a greater percentage of outside directors.[19]

While fraud firms had significantly more inside directors than no-fraud firms in the 1991-1999 sub-period, this difference did not continue in the 2001-2004 sub-period.

[19] We occasionally highlight shifts in overall trends by comparing findings from the 1991-1999 sub-period and findings from the 2001-2004 sub-period to provide insights about apparent trends over time. However, we have not performed formal statistical tests of noted differences between the two sub-periods.

Table 11. Board of Director Composition (Means)

	Full Sample					1991-1999 Sample					2001-2004 Sample				
	# of Pairs of Firms	Fraud Sample	No-Fraud Sample	Fraud – No-Fraud	p-value	# of Pairs of Firms	Fraud Sample	No-Fraud Sample	Fraud – No-Fraud	p-value	# of Pairs of Firms	Fraud Sample	No-Fraud Sample	Fraud – No-Fraud	p-value
Number of board members	203	7.7	8.0	-0.3		113	7.4	7.8	-0.4		52	7.9	8.0	-0.1	
Type of board member:															
Inside director	203	30%	25%	5%	.010	113	32%	28%	4%	.069	52	25%	23%	2%	
Grey director	203	10%	12%	-2%		113	12%	13%	-1%		52	8%	11%	-3%	
Outside director	203	60%	63%	-3%		113	56%	59%	-3%		52	67%	66%	1%	
Type of grey director:															
Former company officer	63	45%	57%	-12%		41	38%	52%	-14%		13	62%	54%	8%	
Relative of management	63	7%	18%	-11%	.086	41	9%	21%	-12%		13	4%	15%	-11%	
Consultant to company	63	25%	16%	9%		41	32%	14%	18%	.034	13	8%	8%	0%	
Outside legal counsel	63	15%	10%	5%		41	15%	10%	5%		13	19%	15%	4%	
Interlocking director	63	4%	4%	0%		41	5%	6%	-1%		13	4%	0%	4%	
Banker	63	0%	0%	0%		41	0%	0%	0%		13	0%	0%	0%	
Non-bank creditor	63	0%	0%	0%		41	0%	0%	0%		13	0%	0%	0%	
Officer of significant supplier or customer	63	2%	0%	2%		41	2%	0%	2%		13	4%	0%	4%	

Note: A p-value that is less than 0.10 indicates that the difference between fraud and no-fraud firms was statistically significant (two-tailed).

Board Member Age, Tenure, and Expertise

We also gathered data about specific characteristics of individuals who served on the boards of the fraud and no-fraud firms. Results are reported in Table 12. The age of the average board member was approximately the same for the fraud and no-fraud firms (53.9 and 54.3 years of age, respectively).

Board members of fraud firms had served on the fraud company's board for 6.7 years on average before the first year of the fraud, which was statistically lower than the average of 7.7 years that directors of no-fraud firms served (p-value = 0.010). Thus, individuals serving on the boards of fraud firms had fewer years of experience on that board relative to individuals serving on no-fraud firm boards.

Surprisingly, on average, 11 percent of fraud firms' board members had accounting or finance expertise as compared to 9 percent for the no-fraud firms, a difference that was statistically significant (p-value = 0.052). More than half of the firms in both the fraud and no-fraud groups had at least one accounting or financial expert on the board (57 percent and 51 percent, respectively; these were not statistically different).

While the average tenure of fraud firm directors was significantly lower than for no-fraud firms, there may be little practical significance in this difference.

We also examined each board member's director experience by measuring how many other directorships were held by each individual director. The average board member served on one other corporate board (1.1 other directorships for individuals serving on fraud firm boards, 0.9 other directorships for no-fraud firms). Also, only 16 percent of fraud firms and 15 percent of no-fraud firms had boards where not one director served on any other corporate board. The difference between fraud and no-fraud firms was not statistically significant.

The results in the two sub-periods (1991-1999 and 2001-2004) were generally consistent with those reported above. Differences in director tenure were only statistically significant for the 1991-1999 sub-period (p-value = 0.029).

The length of board tenure was not statistically different between fraud and no-fraud firms for 2001-2004. Also, the average percentage of directors with accounting or finance expertise was higher for fraud firms (12 percent of the fraud firm board) than for no-fraud firms (8 percent of the no-fraud firm board) in the 1991-1999 sub-period (p-value = 0.017).

The percentage of boards with at least one director with accounting or financial expertise was greater in the latter period, for both fraud and no-fraud firms. Also, the chance that a board would have no members who sit on the board of another firm was lower in the 2001-2004 sub-period, for both fraud and no-fraud firms.

Stock Ownership

We obtained data about the extent of company stock owned by directors and officers of the company. Stock ownership information was available for 196 of the 203 pairs of fraud and no-fraud firms. This information is reported in Table 13.

Table 12. **Individual Director Characteristics** (Means)

	Full Sample					1991-1999 Sample					2001-2004 Sample				
	# of Pairs of Firms	Fraud Sample	No-Fraud Sample	Fraud – No-Fraud	p-value	# of Pairs of Firms	Fraud Sample	No-Fraud Sample	Fraud – No-Fraud	p-value	# of Pairs of Firms	Fraud Sample	No-Fraud Sample	Fraud – No-Fraud	p-value
Director age	203	53.9	54.3	-0.4		113	54.2	53.6	0.6		52	53.6	55.3	-1.7	
Director tenure on board (in years)	203	6.7	7.7	-1.0	.010	113	6.7	7.8	-1.1	.029	52	6.9	8.0	-1.1	
Percentage of board members with accounting or finance expertise	203	11%	9%	2%	.052	113	12%	8%	4%	.017	52	13%	11%	2%	
Percentage of companies with at least one accounting or finance expert on board	203	57%	51%	6%		113	56%	47%	9%		52	67%	60%	7%	
Average number of other directorships held by board members	203	1.1	0.9	0.2		113	1.0	0.9	0.1		52	1.1	0.9	0.2	
Percentage of companies where not one member of the board held any other directorships	203	16%	15%	1%		113	19%	22%	-3%		52	13%	10%	3%	

Note: A p-value that is less than 0.10 indicates that the difference between fraud and no-fraud firms was statistically significant (two-tailed).

Directors and officers owned a significant percentage of the stock of both the fraud and no-fraud firms (23 percent and 22 percent of outstanding common shares, respectively). On average, the highest-ranking officer owned 9 percent of the stock for both groups, and the largest stockholder among the officers and directors owned 15 percent of the stock for fraud firms as compared to 13 percent for no-fraud firms. None of the differences was statistically significant. The results for the two sub-periods are consistent with the full sample results.

> **There was no difference in stock ownership held by officers and directors between fraud and no-fraud firms.**

Board Chair and CEO Age and Tenure

We gathered data about certain characteristics of the individuals serving as board chair and as CEO. The results are reported in Table 13. We collected data about the type of director serving as the chairman of the board for 182 of the 203 pairs of fraud and no-fraud firms. The chairman of the board was an inside director in at least 70 percent of both fraud and no-fraud firms (75 percent of fraud firms and 70 percent of no-fraud firms had an inside director as chairman). This likely reflects the prevalence in the U.S. of assigning both the position of CEO and board chair to the same individual. Interestingly, the percentage of firms whose chairman of the board was a grey director was 11 percent for fraud firms as compared to 19 percent for no-fraud firms, a difference that is statistically significant (p-value = 0.039). That result was also statistically significant for the 1991-1999 sub-period (p-value = 0.046).

We found that, on average, the CEO was approximately 51 years old for both fraud and no-fraud firms. CEO tenure, which reflects the number of years the individual had served as CEO of the firm, was approximately 10 years for both fraud and no-fraud firms (9.4 years for fraud firms, 10.2 years for no-fraud firms). These results were not statistically different for the full sample. However, the average age of CEOs in the 2001-2004 sub-period was 49.9 years old for fraud firms as compared to 53.2 years old for no-fraud firms. The difference was statistically significant (p-value = 0.051). Similarly, the average CEO tenure was statistically lower for fraud firms relative to no-fraud firms for the 2001-2004 sub-period (p-value = 0.098).

Table 13. Stock Ownership by Directors and Officers; Board Chair and CEO Traits (Means)

	Full Sample					1991-1999 Sample					2001-2004 Sample				
	# of Pairs of Firms	Fraud Sample	No-Fraud Sample	Fraud – No-Fraud	p-value	# of Pairs of Firms	Fraud Sample	No-Fraud Sample	Fraud – No-Fraud	p-value	# of Pairs of Firms	Fraud Sample	No-Fraud Sample	Fraud – No-Fraud	p-value
Stock owned by directors and officers	196	23%	22%	1%		107	24%	23%	1%		52	18%	21%	-3%	
Stock owned by the highest-ranking officer	196	9%	9%	0%		107	11%	10%	1%		52	7%	7%	0%	
Stock owned by the largest holder among officers and directors	196	15%	13%	2%		107	17%	14%	3%		52	12%	13%	-1%	
Type of board chair:															
Inside director	182	75%	70%	5%		99	80%	76%	4%		48	64%	56%	8%	
Grey director	182	11%	19%	-8%	.039	99	7%	16%	-9%	.046	48	17%	25%	-8%	
Outside director	182	14%	11%	3%		99	13%	8%	5%		48	19%	19%	0%	
CEO age (in years)	203	50.7	51.4	-0.7		113	51.7	50.6	1.1		52	49.9	53.2	-3.3	.051
CEO tenure (in years)	203	9.4	10.2	-0.8		113	10.1	10.2	-0.1		52	8.3	11.1	-2.8	.098

Note: A p-value that is less than 0.10 indicates that the difference between fraud and no-fraud firms was statistically significant (two-tailed).

Number of Board Meetings Per Year

Boards of fraud firms met significantly more often than boards of no-fraud firms. This difference may reflect the fact that fraud firms often experienced financial stress preceding the fraud period, which precipitated additional board meetings.

We gathered data about the number of board meetings held during the year. That information is reported in Table 14. Perhaps surprisingly, boards of fraud firms met significantly more often (7.7 meetings per year) than boards of no-fraud firms (6.6 meetings per year) (p-value = 0.001). There was no difference between fraud and no-fraud firms in the average number of board meetings for the 1991-1999 sub-period, but fraud firms had statistically more board meetings than no-fraud firms for the 2001-2004 sub-period (p-value = 0.005). These differences may reflect the fact that fraud firms often experienced financial stress, perhaps precipitating additional board meetings.

Director Turnover

As shown in Table 14, the number of directors who left the board during the first fraud year was generally quite small (an average of 0.2 directors left fraud firm boards as compared to an average of 0.4 directors leaving no-fraud boards), but this difference was statistically significant (p-value = 0.045). Fifteen percent of fraud firms had a director leave the board during the first fraud year, while 25 percent of the no-fraud firms had a director leave the board during the comparable year, and this difference was statistically significant (p-value = 0.018). Thus, during the first fraud year, director turnover was lower for fraud firms than for no-fraud firms.

During the 1st fraud year, director turnover was lower for fraud firms than for no-fraud firms.

There was no difference between fraud and no-fraud firms in the number of directors who left the board during the first fraud year in either of the two sub-periods. However, during the 1991-1999 sub-period, 13 percent of fraud and 23 percent of no-fraud firms had a director leave the board during the first fraud year, a difference that was statistically significant (p-value = 0.058). During the 2001-2004 sub-period, the same percentage (25 percent) of fraud and no-fraud firms had a director leave the board during the first fraud year.

Blockholders

Often an individual or entity owns a significant portion of a company's common shares. These are generally referred to as "blockholders." Consistent with corporate governance literature, we defined an outside blockholder as an individual or an entity that owned five percent or more of the firm's stock. We gathered data about the extent of blockholder ownership, which also is reported in Table 14.

We found that approximately two-thirds of both fraud and no-fraud firms had an outside blockholder who was not a director (67 percent of fraud firms and 74 percent of no-fraud firms). Also, 23 percent of fraud and 24 percent of no-fraud firms had an outside blockholder who was a director.

During the 1991-1999 sub-period, fraud companies were significantly less likely to have an outside blockholder who was not a director. Fifty-eight percent of fraud firms had a blockholder who was not a director, while 75 percent of no-fraud firms had a blockholder who was not a director. That difference was statistically significant (p-value = 0.009). That difference did not continue for the 2001-2004 sub-period.

Internal Audit

Requirements to disclose the existence of an internal audit function did not exist for the entire period of the study. We identified disclosures (some were voluntary) of an internal audit function for approximately 30 percent of both the fraud and no-fraud firms during the full sample time period. Disclosure of an internal audit group was much more likely in the 2001-2004 sub-period than in the 1991-1999 sub-period for both fraud and no-fraud firms. Less than 20 percent of firms voluntarily disclosed having an internal audit function in the 1991-1999 sub-period, while about 50 percent of firms disclosed having an internal audit function in the 2001-2004 sub-period.

Table 14. Other Full Board and Governance Characteristics (Means)

	Full Sample					1991-1999 Sample					2001-2004 Sample				
	# of Pairs of Firms	Fraud Sample	No-Fraud Sample	Fraud — No-Fraud	p-value	# of Pairs of Firms	Fraud Sample	No-Fraud Sample	Fraud — No-Fraud	p-value	# of Pairs of Firms	Fraud Sample	No-Fraud Sample	Fraud — No-Fraud	p-value
Number of board meetings per year	183	7.7	6.6	1.1	.001	99	7.6	6.6	1.0		49	8.0	6.2	1.8	.005
Number of directors who left the board during the first fraud year	203	0.2	0.4	-0.2	.045	113	0.2	0.4	-0.2		52	0.4	0.3	0.1	
Percentage of companies that had a director leave during the first fraud year	203	15%	25%	-10%	.018	113	13%	23%	-10%	.058	52	25%	25%	0%	
Percentage of companies w/ an outside blockholder who was not a director	196	67%	74%	-7%		107	58%	75%	-17%	.009	52	77%	77%	0%	
Percentage of companies w/ an outside blockholder who was a director	196	23%	24%	-1%		107	21%	19%	2%		52	21%	29%	-8%	
Percentage of companies disclosing existence of an internal audit function	203	32%	29%	3%		113	19%	18%	1%		52	50%	48%	2%	

Note: A p-value that is less than 0.10 indicates that the difference between fraud and no-fraud firms was statistically significant (two-tailed).

Audit Committee Characteristics

Audit committees are generally responsible for the board's oversight of the financial reporting process. We gathered extensive information about selected audit committee characteristics. Among the set of 203 pairs of fraud and no-fraud firms, 193 fraud firms had an audit committee and 199 no-fraud firms had an audit committee. So that we could continue to have a set of fraud companies similarly paired with no-fraud companies, we reduced the size of the sample for our analysis of audit committee characteristics to 188 pairs of fraud and no-fraud firms that both had audit committees. This same reasoning applies to the other variables where the sample size was less than 203.

Existence, Size, Independence, and Meeting Frequency

As reported in Table 15, 95 percent of fraud firms maintained an audit committee, while 98 percent of no-fraud firms maintained an audit committee (the difference was statistically significant (p-value = 0.066)). The average size of audit committees for both fraud and no-fraud firms was about three members. Consistent with the Blue Ribbon Committee (BRC) Report recommendation that audit committees have at least three members (a recommendation subsequently adopted by the stock exchanges) 70 percent of the fraud firms and 79 percent of no-fraud firms maintained an audit committee with at least three members. The difference was statistically significant (p-value = 0.044).

Few differences existed between audit committees of fraud firms and no-fraud firms.

On average, the audit committees of fraud firms had more inside directors (5 percent of the audit committee membership) than the audit committees of no-fraud firms (2 percent), and that difference was statistically significant (p-value = 0.008). Likewise, 87 percent of fraud firms had no insiders on the audit committee, versus 94 percent of no-fraud firms. This difference was significant (p-value = 0.014). Sixty-four percent of the fraud firms and 67 percent of no-fraud firms maintained an audit committee that was composed entirely (100 percent of the audit committee membership) of outside, independent directors. This difference was not statistically significant.

In both sub-periods, there were no differences between fraud and no-fraud firms in audit committee existence or average audit committee size. Only in the 1991-1999 sub-period, the percentage of fraud firms with an audit committee composed of at least three members was significantly lower than for no-fraud firms (p-value = 0.050).

Relating to audit committee independence, the only statistically significant difference between fraud and no-fraud firms in the sub-periods was that fraud firms had more inside directors than no-fraud firms, but this result only held for the 1991-1999 sub-period (8 percent and 3 percent, respectively (p-value = 0.037)). Likewise, no-fraud firms in the 1991-1999 sub-period were more likely to have no insiders on the audit committee (p-value = 0.048). Audit committees were more independent in the 2001-2004 sub-period than in the 1991-1999 sub-period for both fraud and no-fraud firms.

Finally, the average number of audit committee meetings per year was 3.5 for fraud firms and 3.7 for no-fraud firms, and about half of all audit committees met four or more times per year. There were no significant differences between fraud and no-fraud firms in the full sample or in either sub-period.

Table 15. Audit Committee Existence, Size, Independence, and Meeting Frequency (Means)

	Full Sample					1991-1999 Sample					2001-2004 Sample				
	# of Pairs of Firms	Fraud Sample	No-Fraud Sample	Fraud — No-Fraud	p-value	# of Pairs of Firms	Fraud Sample	No-Fraud Sample	Fraud — No-Fraud	p-value	# of Pairs of Firms	Fraud Sample	No-Fraud Sample	Fraud — No-Fraud	p-value
Existence of an audit committee	203	95%	98%	-3%	.066	113	92%	96%	-4%		52	98%	100%	-2%	
Number of individuals on audit committee	188	3.1	3.2	-0.1		100	3.0	3.2	-0.2		51	3.4	3.4	0	
Percentage of companies with an audit committe composed of at least three members	188	70%	79%	-9%	.044	100	61%	74%	-13%	.050	51	92%	92%	0%	
Type of audit committee board member:															
Inside director	188	5%	2%	3%	.008	100	8%	3%	5%	.037	51	3%	1%	2%	
Grey director	188	11%	11%	0%		100	13%	15%	-2%		51	8%	7%	1%	
Outside director	188	84%	87%	-3%		100	79%	82%	-3%		51	89%	92%	-3%	
Percentage of companies with an audit committe consisting of no inside directors	188	87%	94%	-7%	.014	100	80%	90%	-10%	.048	51	96%	98%	-2%	
Percentage of companies whose audit committee consisted entirely of outside directors	188	64%	67%	-3%		100	53%	56%	-3%		51	76%	78%	-2%	
Number of audit committee meetings per year	170	3.5	3.7	-0.2		93	2.6	2.9	-0.3		47	5.1	4.9	0.2	
Percentage of companies where audit committee met at least four times per year	170	45%	51%	-6%		93	23%	31%	-8%		47	81%	85%	-4%	

Note: A p-value that is less than 0.10 indicates that the difference between fraud and no-fraud firms was statistically significant (two-tailed).

Financial Expertise and Governance Expertise

We also gathered data about the expertise of individuals who served on the audit committee. A board member was coded as having accounting or finance expertise if he or she had current or prior experience as a CFO, CPA, controller, or vice president of finance. Results are provided in Table 16. On average, 14 percent of audit committee members for fraud and 10 percent for no-fraud firms had accounting or finance expertise. That difference was statistically significant for the full sample (p-value = 0.053) and for the 1991-1999 sub-period (p-value = 0.006). Similarly, in the 1991-1999 sub-period, 33 percent of the fraud firms and only 20 percent of no-fraud firms had at least one audit committee member with accounting or finance expertise, a significant difference (p-value = 0.037). Both fraud and no-fraud firms were more likely to have at least one financial expert on the audit committee in more recent years.

Surprisingly, the percentage of individuals on audit committees with finance or accounting expertise was significantly higher for fraud firms than no-fraud firms for the full sample and the 1991-1999 sub-period.

Table 16. Other Audit Committee Characteristics (Means)

	Full Sample					1991-1999 Sample					2001-2004 Sample				
	# of Pairs of Firms	Fraud Sample	No-Fraud Sample	Fraud – No-Fraud	p-value	# of Pairs of Firms	Fraud Sample	No-Fraud Sample	Fraud – No-Fraud	p-value	# of Pairs of Firms	Fraud Sample	No-Fraud Sample	Fraud – No-Fraud	p-value
Percentage of audit committee members with accounting or finance expertise	188	14%	10%	4%	.053	100	15%	7%	8%	.006	51	16%	16%	0%	
Percentage of audit committees with at least one accounting or finance expert	188	34%	28%	6%		100	33%	20%	13%	.037	51	43%	43%	0%	
Average number of director positions held by audit committee members on other company boards	188	1.2	1.1	.1		100	1.2	1.0	.2		51	1.2	1.0	.2	
Type of audit committee chair:															
Inside director	43	2%	0%	2%		17	6%	0%	6%		16	0%	0%	0%	
Grey director	43	5%	9%	-4%		17	6%	6%	0%		16	6%	19%	-13%	
Outside director	43	93%	91%	2%		17	88%	94%	-6%		16	94%	81%	13%	
Percentage of audit committees whose chair had accounting or finance expertise	43	21%	14%	7%		17	18%	0%	18%	.070	16	19%	31%	-12%	
Percentage of companies that included audit committee report or charter in proxy	203	32%	35%	-3%		113	3%	1%	2%		52	81%	94%	-13%	.038
Percentage of audit committee members who joined audit committee after CEO appointed	188	77%	75%	2%		100	81%	73%	8%		51	73%	75%	-2%	
Percentage of audit committees whose chair joined board after CEO appointed	43	67%	67%	0%		17	59%	59%	0%		16	81%	88%	-7%	

Note: A p-value that is less than 0.10 indicates that the difference between fraud and no-fraud firms was statistically significant (two-tailed).

Because experience serving as a director might impact an individual's effectiveness as a board member, we collected data about the average number of director positions held on other company boards (other than the relevant fraud or no-fraud firms) by audit committee members. We found that average was similar for fraud and no-fraud firms (1.2 and 1.1 other directorships held by audit committee members for fraud and no-fraud firms, respectively).

Audit Committee Chair, Charter, and Committee Appointment Process

The overwhelming majority of audit committee chairs were outside directors (93 percent for fraud and 91 percent for no-fraud firms, respectively; difference not statistically significant).[20] Overall, relatively few audit committee chairs had accounting or finance expertise, with no significant difference between fraud and no-fraud firms. However, for the 1991-1999 sub-period, 18 percent of the audit committee chairs of fraud firms and zero percent of audit committee chairs of no-fraud firms had accounting or finance expertise; this difference was statistically significant (p-value = 0.070).

Thirty-two percent of the fraud and 35 percent of no-fraud firms in the full sample included the audit committee report or charter in the proxy statement (difference not statistically significant). Only three percent of fraud firms and one percent of no-fraud firms included an audit committee report or charter in the proxy during 1991-1999. However, during the 2001-2004 sub-period, 81 percent of fraud firms and 94 percent of no-fraud firms included an audit committee report or charter in the proxy statement. The difference during the 2001-2004 sub-period between fraud and no-fraud firms was statistically different (p-value = 0.038). Charters became much more common in proxy statements as a result of a BRC Report recommendation that was adopted by the stock exchanges.

In the 2001-2004 sub-period, fraud firms were less likely than no-fraud firms to include an audit committee charter or report in the proxy.

We also gathered data on whether audit committee members, including the committee chair, joined the board after the current CEO (at the time the fraud began) was appointed. To the extent that a greater percentage of committee members joined the board after the current CEO was appointed, the current CEO may have played a greater role in their appointment and, as a result, may have had greater influence over the respective board committee. For both fraud and no-fraud firms, at least two-thirds of audit committee members and chairs were appointed after the current CEO assumed his or her position, with differences not statistically different in the full sample or either sub-period.

Compensation Committee Characteristics

We gathered information about several characteristics of the companies' compensation committees. The analysis of this information is provided in the sections that follow. We analyzed compensation committees because compensation, especially executive compensation, can affect management's motivation to commit fraud.

Existence, Size, Independence, and Meeting Frequency

As reported in Table 17, fraud firms were significantly less likely to have maintained a compensation committee than no-fraud firms. While 88 percent of fraud firms maintained a compensation committee, 94 percent of no-fraud firms maintained a compensation committee. That difference was significant (p-value = 0.058). The average compensation committee size was 3.1 members for fraud firms and 3.2 members for no-fraud firms. Sixty-nine percent of the fraud and 75 percent of no-fraud firms maintained a compensation committee with at least three members. These differences were not statistically significant.

A large majority of both fraud and no-fraud firms had compensation committees, and there were relatively few differences in the characteristics of those committees between fraud and no-fraud firms.

As for the composition of compensation committees, 85 percent of fraud firm compensation committee membership and 88 percent of no-fraud firm compensation committee membership consisted of outside directors. This difference was not statistically significant. Eighty-nine percent of the fraud firms and 90 percent of no-fraud firms had a compensation committee with no insiders; this difference was not statistically significant. Also, 66 percent of the fraud and 70 percent of no-fraud firms maintained a compensation committee that was composed entirely of outside, independent directors. This difference was not statistically significant.

[20] Only 43 pairs of firms disclosed the name of the chair of the audit committee. Given the small sample size, results related to the audit committee chair should be interpreted with caution.

Table 17. Compensation Committee Existence, Size, Independence, and Meeting Frequency (Means)

	Full Sample					1991-1999 Sample					2001-2004 Sample				
	# of Pairs of Firms	Fraud Sample	No-Fraud Sample	Fraud — No-Fraud	p-value	# of Pairs of Firms	Fraud Sample	No-Fraud Sample	Fraud — No-Fraud	p-value	# of Pairs of Firms	Fraud Sample	No-Fraud Sample	Fraud — No-Fraud	p-value
Existence of a compensation committee	203	88%	94%	-6%	.058	113	84%	90%	-6%		52	94%	98%	-4%	
Number of individuals on compensation committee	170	3.1	3.2	-0.1		88	3.0	3.1	-0.1		48	3.3	3.1	0.2	
Percentage of companies with a compensation committee composed of at least three members	170	69%	75%	-6%		88	69%	76%	-7%		48	77%	67%	10%	
Type of compensation committee member:															
Inside director	170	4%	3%	1%		88	4%	4%	0%		48	6%	3%	3%	
Grey director	170	11%	9%	2%		88	12%	10%	2%		48	8%	8%	0%	
Outside director	170	85%	88%	-3%		88	84%	86%	-2%		48	86%	89%	-3%	
Percentage of companies with a compensation committee consisted of no inside directors	170	89%	90%	-1%		88	90%	88%	2%		48	85%	92%	-7%	
Percentage of companies with compensation committee consisted entirely of outside directors	170	66%	70%	-4%		88	64%	69%	-5%		48	71%	69%	2%	
Number of compensation committee meetings per year	153	3.3	3.2	0.1		80	3.1	3.0	0.1		46	3.5	3.4	0.1	
Percentage of companies where compensation committee met at least two times per year	153	73%	74%	-1%		80	70%	74%	-4%		46	78%	70%	8%	

Note: A p-value that is less than 0.10 indicates that the difference between fraud and no-fraud firms was statistically significant (two-tailed).

The average number of compensation committee meetings per year was 3.3 for fraud firms and 3.2 for no-fraud firms. Also, 73 percent of fraud firm compensation committees and 74 percent of no-fraud firm compensation committees met at least two times per year. Neither difference was significant.

While for the full sample, fraud firms were less likely to have had a compensation committee, this difference between fraud and no-fraud firms for each of the two sub-periods was not statistically significant. In both sub-periods, there were no other significant differences between fraud and no-fraud firms with respect to compensation committee characteristics in Table 17. Finally, unlike the case for audit committees, there was no notable improvement in compensation committee independence across the two sub-periods.

Financial Expertise and Governance Expertise

Because components of executive compensation are sometimes based on financial statement outcome measures (e.g., bonus based on earnings), we examined the extent to which compensation committees are composed of individuals with accounting or finance expertise. Table 18 reports that, on average, nine percent of compensation committee members for fraud firms and five percent of no-fraud firms' compensation committee members had accounting or finance expertise. Also, 22 percent of the fraud firms and 14 percent of no-fraud firms had at least one member with accounting or finance expertise on the compensation committee. Both differences were statistically significant (p-values = 0.012 and 0.034, respectively). The average number of other director positions held by compensation committee members was similar for fraud and no-fraud firms (1.3 and 1.2, respectively).

Similar to the full sample results, the percentage (10 percent) of compensation committee members having accounting or finance expertise was statistically higher for fraud firms than the percentage (4 percent) for no-fraud firms in the 1991-1999 sub-period (p-value = 0.018). Similarly, in the 1991-1999 sub-period, 23 percent of fraud firms had at least one accounting or finance expert on the compensation committee, versus 11 percent of no-fraud firms (p-value = 0.045). The differences between the fraud and no-fraud firms in the 2001-2004 sub-period related to accounting and finance expertise on the compensation committee were not significant. There was no statistically significant difference between the fraud and the no-fraud firms in the average number of other directorships held by compensation committee members in either sub-period.

Surprisingly, the percentage of individuals on compensation committees with finance or accounting expertise was significantly higher for fraud firms than no-fraud firms for the full sample and the 1991-1999 sub-period.

Compensation Committee Chair and Committee Appointment Process

The overwhelming majority of compensation committee chairs were outside directors (89 percent for fraud and 97 percent for no-fraud firms; not statistically significant).[21] Virtually none of the compensation committee chairs had accounting or finance expertise. This finding is interesting given the accounting and financial implications of firm compensation practices and the associated fraud risk that certain compensation practices may entail.

Seventy-five percent of the fraud firm compensation committee members joined the board after the CEO was appointed as compared to 70 percent for no-fraud firms. That difference was not statistically significant. There also was no statistical difference between fraud and no-fraud firms in whether the compensation committee chair joined the board after the CEO assumed his or her position.

There was no statistically significant difference between the fraud and no-fraud firms, in either sub-period, in the percentage of outside directors serving as chair of the compensation committee or in the percentage of committee chairs with accounting or finance expertise. Compensation committee members of fraud firms were significantly more likely than no-fraud firms to have joined the board after the CEO assumed his or her position in the 1991-1999 sub-period (80 percent for fraud firms compared to 67 percent for no-fraud firms (p-value = 0.031)). This result did not continue in the 2001-2004 sub-period. There was no difference, in either sub-period, between fraud and no-fraud firms as it relates to the compensation committee chair joining after the CEO was appointed.

[21] Only 38 pairs of firms disclosed the name of the chair of the compensation committee. Given the small sample size, results related to the compensation committee chair should be interpreted with caution.

Table 18. Other Compensation Committee Characteristics (Means)

	Full Sample					1991-1999 Sample					2001-2004 Sample				
	# of Pairs of Firms	Fraud Sample	No-Fraud Sample	Fraud – No-Fraud	p-value	# of Pairs of Firms	Fraud Sample	No-Fraud Sample	Fraud – No-Fraud	p-value	# of Pairs of Firms	Fraud Sample	No-Fraud Sample	Fraud – No-Fraud	p-value
Percentage of compensation committee members with accounting or finance expertise	170	9%	5%	4%	.012	88	10%	4%	6%	.018	48	10%	6%	4%	
Percentage of compensation committees w/ at least one accounting or finance expert	170	22%	14%	8%	.034	88	23%	11%	12%	.045	48	27%	15%	12%	
Average number of director positions held by compensation committee members on other company boards	170	1.3	1.2	0.1		88	1.3	1.3	0.0		48	1.3	1.0	0.3	
Type of compensation committee chair:															
Inside director	38	3%	0%	3%		15	0%	0%	0%		13	8%	0%	8%	
Grey director	38	8%	3%	5%		15	13%	0%	13%		13	0%	8%	-8%	
Outside director	38	89%	97%	-8%		15	87%	100%	-13%		13	92%	92%	0%	
Percentage of compensation committees whose chair had accounting or finance expertise	38	0%	3%	-3%		15	0%	0%	0%		13	0%	8%	-8%	
Percentage of compensation committee members who joined compensation committee after CEO appointed	170	75%	70%	5%		88	80%	67%	13%	.031	48	67%	70%	-3%	
Percentage of compensation committees whose chair joined board after CEO appointed	38	61%	68%	-7%		15	67%	53%	14%		13	62%	77%	-15%	

Note: A p-value that is less than 0.10 indicates that the difference between fraud and no-fraud firms was statistically significant (two-tailed).

Board Leadership Issues and Related Party Transactions

Board Leadership Issues, Appointment Process, and Personal Relationships[22]

As reported in Table 19, and consistent with the general practice in the U.S., the CEO also served as chairman of the board in more than two-thirds of both fraud and no-fraud firms. There was no statistically significant difference between fraud and no-fraud firms. We also examined the role of the company's founder in the firm's governance process. The CEO was also the company's founder for 27 percent of fraud firms as compared to 22 percent for no-fraud firms; however, that difference was not statistically significant.

The founder was on the board of directors for 42 percent of the fraud firms as compared to 36 percent for no-fraud firms, but the difference was not statistically significant. Approximately 80 percent of directors joined the board after the CEO assumed his or her position, and there was no statistically significant difference between the fraud and no-fraud firms. Finally, family relationships among

[22] We attempted to gather data on nominating committee characteristics as well. However, we only had 28 pairs of observations with nominating committee data. Given this small sample, we chose not to present any data. Notwithstanding this fact, fraud companies were less likely to have a nominating committee (p-value = 0.056), although this result only held in the 1991-1999 sub-period.

non-employee directors and company officers existed for 6 percent of the fraud companies as compared to 13 percent for the no-fraud companies. That difference was statistically significant (p-value = 0.012) for the full sample and for the 2001-2004 sub-period (p-value = 0.008).

Table 19. Board Leadership Issues (Means)

	Full Sample					1991-1999 Sample					2001-2004 Sample				
	# of Pairs of Firms	Fraud Sample	No-Fraud Sample	Fraud – No-Fraud	p-value	# of Pairs of Firms	Fraud Sample	No-Fraud Sample	Fraud – No-Fraud	p-value	# of Pairs of Firms	Fraud Sample	No-Fraud Sample	Fraud – No-Fraud	p-value
Percentage of companies where CEO/President and board chair were the same individual	192	70%	68%	2%		105	70%	70%	0%		50	66%	58%	8%	
Percentage of companies where CEO/President and the company founder were the same individual	203	27%	22%	5%		113	29%	23%	6%		52	19%	19%	0%	
Percentage of companies where the company founder served on the board	203	42%	36%	6%		113	42%	36%	6%		52	35%	37%	-2%	
Percentage of board members who joined board after CEO appointed	203	80%	77%	3%		113	82%	77%	5%		52	77%	77%	0%	
Percentage of companies where board had at least one non-employee director related to an officer of the company	203	6%	13%	-7%	.012	113	8%	11%	-3%		52	2%	17%	-15%	.008

Note: A p-value that is less than 0.10 indicates that the difference between fraud and no-fraud firms was statistically significant (two-tailed).

Related Party Transactions

As shown in Table 20, fraudulent financial reporting was more likely when a firm disclosed related party transactions. We found that 79 percent of fraud firms had disclosed a related party transaction in the proxy statement, as compared to 71 percent for no-fraud firms. That difference was statistically significant (p-value = 0.065). However, that difference was not statistically significant for either sub-period.

For fraud firms, 26 percent of the related party transactions involved the founder, whereas 22 percent of the related party transactions involved the founder for the no-fraud firms. This difference was not statistically significant. Related party transactions involving the founder occurred less often in recent years.

Just over 50 percent of the related party transactions involved the CEO, although there was no difference between the fraud and no-fraud firms on an overall basis or in either of the two sub-periods examined. Related party transactions involving other senior officers or involving board members occurred approximately 50-60 percent of the time, but there were no significant differences between fraud and no-fraud firms.

Although over 70% of fraud and no-fraud firms disclosed related party transactions, fraud firms were significantly more likely to have disclosed a related party transaction than no-fraud firms.

Table 20. Related Party Transactions (Means)

	Full Sample					1991-1999 Sample					2001-2004 Sample				
	# of Pairs of Firms	Fraud Sample	No-Fraud Sample	Fraud – No-Fraud	p-value	# of Pairs of Firms	Fraud Sample	No-Fraud Sample	Fraud – No-Fraud	p-value	# of Pairs of Firms	Fraud Sample	No-Fraud Sample	Fraud – No-Fraud	p-value
Percentage of companies with related party transactions disclosed in the proxy	203	79%	71%	8%	.065	113	75%	70%	5%		52	87%	77%	10%	
Percentage of disclosed related party transactions that involved the founder	117	26%	22%	4%		60	28%	27%	1%		35	14%	11%	3%	
Percentage of disclosed related party transactions that involved the CEO	117	51%	54%	-3%		60	58%	53%	5%		35	31%	46%	-15%	
Percentage of disclosed related party transactions that involved other senior officers	117	52%	50%	2%		60	47%	47%	0%		35	51%	51%	0%	
Percentage of disclosed related party transactions that involved members of the board of directors	117	61%	66%	-5%		60	67%	67%	0%		35	51%	60%	-9%	

Note: A p-value that is less than 0.10 indicates that the difference between fraud and no-fraud firms was statistically significant (two-tailed).

Issues Related to the External Auditor

Auditors Associated With Fraud Companies

We obtained information from the COMPUSTAT® database about the auditor who issued the audit opinion on the last set of audited financial statements issued during the fraud period to identify the auditor responsible for issuing the audit opinion on those fraudulently misstated financial statements. We were able to obtain information about the nature of the auditor's opinion for the last fraudulently issued financial statements for 223 of the 347 fraud firms. We were able to obtain auditor data for 247 of the no-fraud firms.[23]

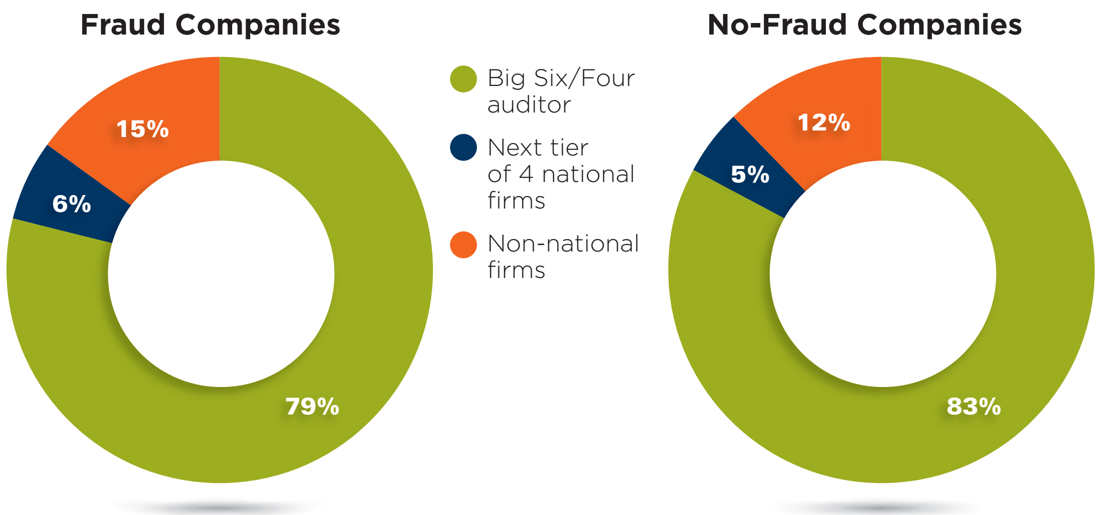
As reported in the pie charts in Table 21, we found that the Big Six/Four audited 79 percent of the fraud companies (177 of the 223 fraud companies with available auditor information) in the last year of the fraud period. The next tier of four national audit firms beyond the Big Six/Four[24] audited 6 percent (n = 13) of the fraud firm financial statements, while the remaining 15 percent (n = 33) of fraud firm financial statements were audited by non-national firms. These percentages were similar to the mix of auditor type for the 247 no-fraud firms where we could locate auditor information.

We also reviewed information about the nature of the auditor's opinion on the last set of financial statements that were fraudulently misstated to determine whether the auditor's report contained any modifications or qualifications. For the 223 fraud companies where we were able to obtain audit opinion data from COMPUSTAT®, we determined that 97 of those 223 audit reports (43 percent) contained unqualified auditor opinions with no explanatory language. An additional 125 of the 223 fraud companies' financial statements (56 percent) contained an auditor's report that included an unqualified opinion along with explanatory language. Only one of the 223 auditor opinions was qualified, and no audit opinion was issued for another of the 223 fraud companies examined (collectively 1 percent).

[23] Our intent was not to compare the nature of audit opinion for a fraud firm and its similar no-fraud firm. Instead, we were interested in comparing auditor characteristics as a whole for each group (fraud firms and no-fraud firms). Thus, we did not need equal numbers of fraud and no-fraud firms for our auditor analysis.

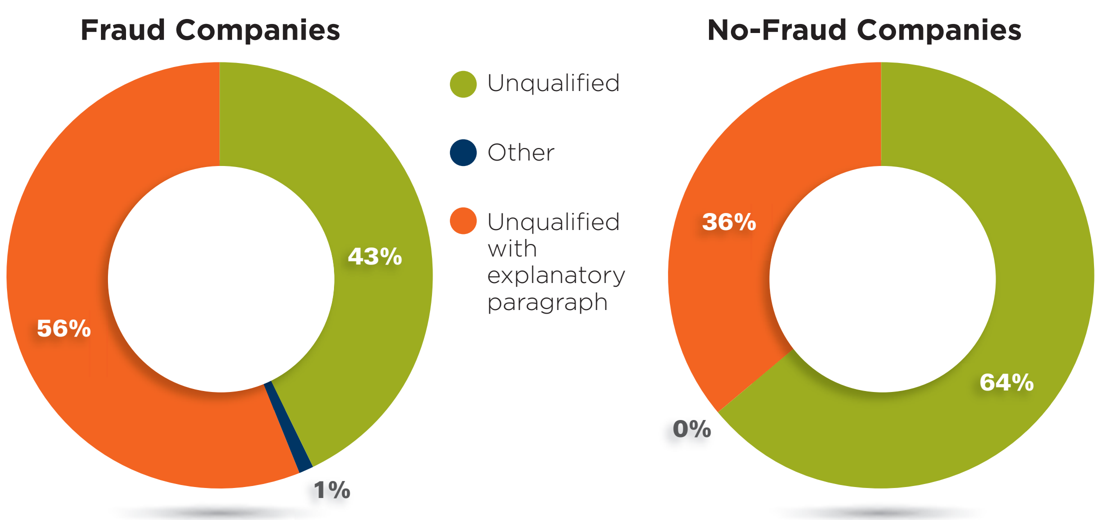
[24] The next tier of four national audit firms is Grant Thornton LLP, BDO Seidman LLP, Crowe Chizek and Company LLC, and McGladrey & Pullen LLP.

Table 21. Size of Audit Firms Issuing Reports



These results differ from the no-fraud firms. The majority of no-fraud firms (64 percent (n = 158) of the 247 no-fraud firms where we had auditor report information) received unqualified audit opinions without any explanatory language, while the remaining 36 percent (n = 88) received unqualified opinions accompanied by explanatory language. No audit opinion was issued for one of the 247 no-fraud companies examined. See the pie charts in Table 22. More research is needed to examine the nature of the audit report modification and to determine if there is any relation between the report modification and the nature of the fraud technique employed.

Table 22. Types of Auditor Reports



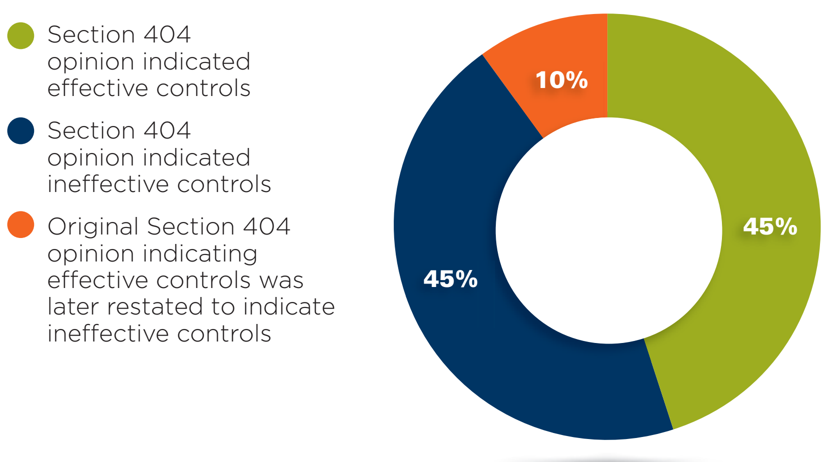
Analysis of Auditor Reports on Internal Control Over Financial Reporting

Because of the significant time lag between the occurrence of fraud and the subsequent issuance by the SEC of an AAER, only a small percentage of the fraud companies had fraud periods extending into 2004 or later, the period when SOX Section 404 internal control audits became mandatory for accelerated filers (effective for fiscal years ended November 15, 2004 or later). We identified 24 fraud companies (40 company years, as some companies had fraud in 2004, 2005, and/or 2006) with fraud periods including 2004 or later that might be subject to the Section 404 requirements, if the company was large enough to be an accelerated filer. Of these 40 company years, 18 did not appear to involve accelerated filers or the company failed to issue a 10-K. This leaves 22 company years for analysis. While we do provide this analysis, we caution readers about drawing conclusions about the impact of Section 404 based on this very small sample size.

In 10 of the 22 cases (45 percent), the Section 404 opinion indicated that the company had effective internal control over financial reporting (see the pie chart in Table 23). Thus, the auditor concluded that controls were effective, even though the company was later determined to have fraudulently misstated its financial statements for this period. In another 10 cases (45 percent), the Section 404 opinion was adverse, indicating ineffective controls. However, in nine of these instances, the auditor's report cited a financial restatement that had already occurred, and in the remaining case, the auditor cited amendments to the original 10-K that were filed immediately after the original 10-K filing (due to auditor-detected issues). Thus, in all of the instances where the auditor concluded that controls were ineffective, there had already been a financial restatement or other amendment of the 10-K. Finally, in two cases (10 percent), the original Section 404 opinion indicated effective controls, but the opinion was subsequently restated to indicate ineffective controls. In both cases, a company financial restatement apparently triggered the restatement of the auditor's Section 404 opinion.

Overall, the analysis of Section 404 opinions for the 22 company years with available data indicates that the opinions indicated effective controls unless there had already been a financial restatement or amended 10-K. Thus, it does not appear that adverse Section 404 opinions were diagnostic of future misstatements, but rather simply reflected already detected misstatements that resulted in financial restatements or amended 10-Ks. However, the small sample size provides a very limited perspective about Section 404 providing fraud detection capability. Further research is warranted to determine whether there are ways to improve auditors' ability to detect internal control weaknesses that may lead to fraud in the future. Additionally, we are unable to assess whether Section 404 serves as a deterrent for management to engage in fraudulent financial reporting.

Table 23. Analysis of Section 404 Internal Control Opinions
(n = 22 company years)



Note: In all cases where the Section 404 opinion indicated ineffective controls, the opinion cited a financial restatement or other amendment of the 10-K.

Alleged Auditor Involvement in the Fraud

In 23 percent of the cases (78 of the 342 fraud cases where the AAERs named individuals), the external auditor was named in an AAER. In five of these 78 fraud cases, two different audit firms were named. Thus, the data in Table 24 describe the accusations against a total of 83 audit firms.[25]

As indicated in Table 24, out of the 83 cases where the auditor was named, 32 audit firms were charged with violating antifraud statutes (either Rule 10(b)-5 of the 1934 Securities Exchange Act or charged with aiding and abetting others in a violation of Rule 10(b)-5). Of those 32 cases, 11 involved a national audit firm (Big Six/Four or the next tier of four national audit firms) and 21 involved a non-national audit firm.

In the remaining 51 cases where the auditor was named, the auditor was accused of violating Rule 102(e) of the 1934 Securities Exchange Act mostly for performing an alleged substandard audit. Out of these 51 cases, 22 involved a national audit firm, while 29 involved a non-national audit firm.

The relative infrequency of enforcement actions against national firms relative to non-national firms is particularly striking, given that most of the fraud firms were audited by a national audit firm. Table 21 indicates that 85 percent of the fraud companies were audited by a national audit firm, yet only 40 percent of the enforcement actions (33 of 83 enforcement actions) were against a national audit firm (see Table 24).

Table 24. Frequency of Audit Firms Named in Enforcement Actions

SEC Alleged Audit Firm Violation	Auditors Named in AAER	Number of National Firms Named	Number of Non-National Firms Named
Anti-fraud statutes	32	11	21
Non-fraud statutes including Rule 102(e)	51	22	29
Total	**83**	**33**	**50**

Note: There were 78 fraud cases in which the SEC named an individual at an audit firm or the audit firm itself in the AAER. For five of the 78 cases, the SEC named individuals at two different audit firms or two different audit firms.

Auditor Changes During Fraud Period

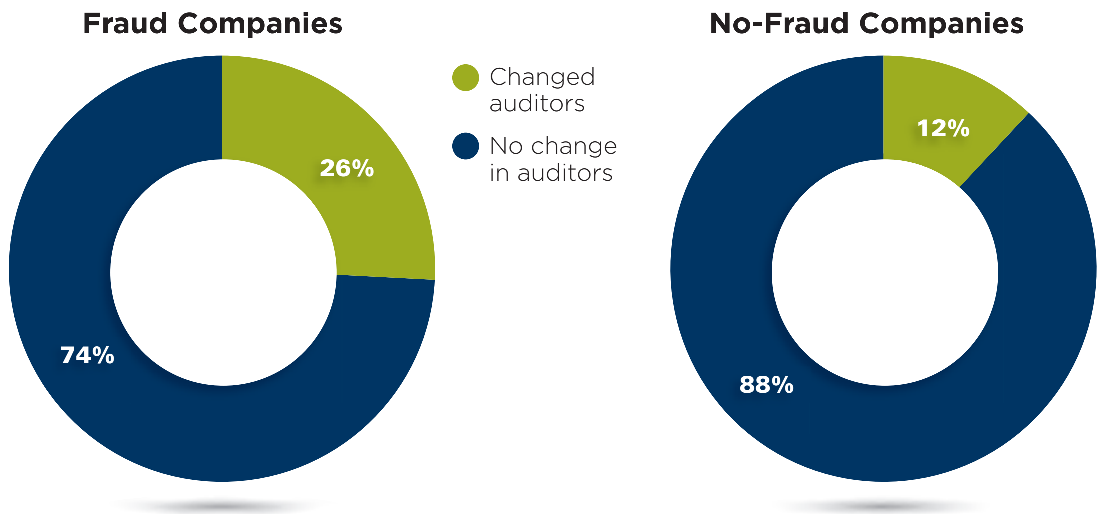
To determine whether fraud companies changed auditors just prior to or during the fraud period, we gathered COMPUSTAT® data to compare the name of the auditor associated with the last clean financial statements to the name of the auditor who issued an audit report on the last fraudulent financial statements. We were able to make that comparison for 184 similarly paired fraud and no-fraud firms. As reflected in the pie charts in Table 25, we found that 47 of the 184 fraud firms (26 percent) changed auditors between the period that the company issued the last clean financial statements and the period the company issued the last set of fraudulent financial statements. In contrast, only 22 of the 184 no-fraud firms (12 percent) switched auditors over that same time frame. This difference was statistically significant (p-value < 0.01).

Twenty-six percent of fraud companies switched auditors between the issuance of the last clean financial statements and the last set of fraudulently misstated financial statements, while 12% of no-fraud firms switched auditors during the same time period.

Most (60 percent) of the fraud firm auditor switches occurred during the fraud period, while the remaining 40 percent of fraud firm auditor switches occurred at the end of the last clean financial statement period (i.e., just before the fraud period began). Of the 47 instances of fraud companies switching auditors, 35 companies (74 percent) switched from one national audit firm to another national audit firm, five (11 percent) switched from a national audit firm to a non-national audit firm, five (11 percent) switched from a non-national audit firm to a national audit firm, and two (4 percent) switched among non-national firms. In contrast, 16 of the 22 no-fraud firms (73 percent) switching auditors changed from one national audit firm to another national audit firm, five (23 percent) switched from a national audit firm to a non-national audit firm, and one (4 percent) switched from a non-national firm to a national firm.

[25] The SEC commonly names an individual auditor in the AAER instead of naming the entire audit firm. For ease of discussion, we refer to the "audit firm" to mean the employer of the named auditor or the firm itself.

Table 25. Auditor Changes



Consequences for the Company and Individuals Involved

We attempted to identify consequences for companies engaging in fraudulent financial reporting once the fraud was revealed. First, we noted consequences described in the AAERs for each of the 347 fraud companies.

Table 26 presents information in the AAERs on the sanctions imposed by the SEC against both companies and individuals as a result of the fraud.[26] The most common sanctions were cease and desist orders, officer and director and SEC bars, and monetary penalties. A cease and desist order compels a party to stop engaging in certain behavior, and the recipient of such an order can be a company or an individual. A cease and desist order is the mildest sanction that the SEC can impose in a fraud case, and it was the most commonly employed sanction (89 percent of the fraud companies received a cease and desist order). Generally, the SEC issues a cease and desist order in addition to other sanctions. However, in 29 cases, the SEC issued a cease and desist order without issuing any other sanctions.

The SEC can bar an individual from serving as an officer or a director of a public company, either for a period of time or permanently. This is a severe sanction, as it seriously affects the economic situation of an individual receiving such a bar. In almost half of the fraud cases (47 percent), one or more individuals received an officer and director bar. In addition, outside professionals (e.g., accountants, attorneys, etc.) can be barred from practicing before the SEC, either temporarily or permanently. In 46 percent of the fraud cases, one or more outside professionals were subject to an SEC bar.

SEC sanctions can involve monetary penalties, either fines or disgorgements. Fines can be levied against companies and individuals, and were imposed in 65 percent of the fraud cases. A disgorgement involves returning monies inappropriately received as a result of the fraud. For example, an individual might be required to disgorge a bonus received based on fraudulently reported income or the proceeds from a stock sale when the stock price was inflated as a result of the fraud. Disgorgements were ordered in 43 percent of the fraud cases.

Fines were imposed in 65% of the cases, while disgorgements were imposed in 43% of the cases. $

[26] Frequencies of consequences reported in this section are inherently understated given that we were only able to identify consequences explicitly noted in an AAER or in business press articles. Given that the business press often does not cover smaller or otherwise less visible companies, there were likely to be many consequences that occurred that we were unable to identify for some of our sample firms.

Table 26. Consequences Based on AAER Information
(n = 347)

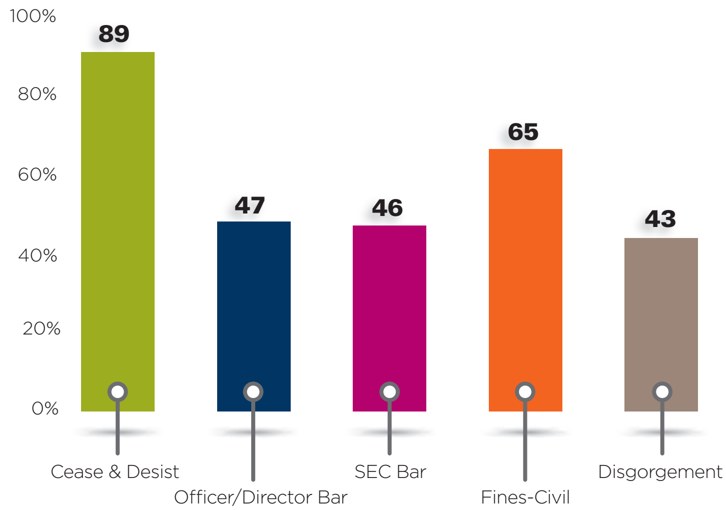


Table 27 presents information on the monetary penalties imposed by the SEC – for cases in which the dollar amounts were disclosed in the AAERs. The average fine imposed by the SEC was $12.4 million, and the median was $100,000 (maximum fine was $750 million). The cumulative fines for all 221 fraud cases imposed by the SEC totaled $2.74 billion. The mean and median disgorgement amounts were $18.1 million and $195,000, respectively (maximum amount of a disgorgement was $700 million). Cumulative disgorgements across all of the 146 fraud cases totaled $2.65 billion.

Table 27. Fines and Disgorgements Based on AAER Information
(n = 347)

Description of Penalty	Number of Companies Identified	Cumulative Amount Paid by All Companies	Mean Amount Paid by a Single Company	Median Amount Paid by a Single Company	Maximum Paid
Fines and settlements	221	$2.74 billion	$12.4 million	$100,000	$750 million
Disgorgements	146	$2.65 billion	$18.1 million	$195,000	$700 million

Other Consequences for Companies

To identify other consequences to the fraud companies for engaging in fraudulent financial reporting, we performed extensive searches of electronic databases of business press articles appearing during the period beginning with the calendar year that coincides with the last year of the fraud and ending with the calendar year two years after the SEC issued the last AAER related to the fraud.

We also performed the search of business press articles for the sample of no-fraud companies. This allows us to determine whether the rate of subsequent consequences was different for fraud companies relative to a similar set of companies not engaging in fraud during the same time periods.

Recall in our earlier analysis of board governance characteristics that we were able to generate a sample of 203 fraud and 203 similar no-fraud firms. As discussed in that section, we were unable to examine board governance variables for the full sample of 347 firms due to the lack of available proxy statements for some firms. For our business press searches, we were able to expand our sample to 311 fraud and 311 no-fraud firms (we were not able to identify a similar no-fraud company in 36 cases).

In addition to SEC sanctions (e.g., fines, disgorgements, cease and desist orders), companies can suffer other consequences either directly, or indirectly, as a result of the fraud. We examined the incidence of financial failure (bankruptcy, liquidation, etc.), stock exchange delisting, and material asset sales for the fraud companies and the comparable percentages for the no-fraud sample.

As shown in Table 28, 28 percent of the fraud companies failed (filed for bankruptcy, were liquidated, etc.) within two years of the latest AAER issued by the SEC. The comparable percentage for the no-fraud companies was 13 percent. The probability of bankruptcy or other failure for a fraud firm was statistically larger than for a no-fraud firm (p-value < 0.001). Similarly, fraud firms were significantly more likely than no-fraud firms to be involuntarily delisted from a stock exchange (p-value < 0.001). Almost half (47 percent) of fraud firms suffered by being delisted by a stock exchange, whereas only 20 percent of no-fraud firms were delisted during a similar time period. Finally, 62 percent of fraud companies compared to 31 percent of no-fraud companies engaged in a material asset sale (p-value < 0.001).

Fraud firms filed for bankruptcy or were delisted from a stock exchange significantly more often in the time period following the fraud than their counterpart no-fraud firms in that same time period.

All of the above metrics clearly indicate that fraud firms were more likely to suffer adverse financial outcomes than no-fraud firms. These differences were likely due to the fact that companies that experienced operating difficulties chose to engage in fraud to mask these difficulties, and to the direct and indirect costs associated with fraud (e.g., legal fees, fines, investigations, reputation damage, loss of personnel, loss of customers, etc.).

Table 28. Other Consequences to Company[a]

(n = 311)[b]

Subsequent Consequences	Fraud Companies Affected	Percentage of Fraud Companies Affected	No-Fraud Companies Affected	Percentage of No-Fraud Companies Affected	p-value[c]
Bankrupt, liquidated, etc.	86	28%	39	13%	.001
Involuntary stock exchange delisting[d]	147	47%	61	20%	.001
Material asset sales	193	62%	96	31%	.001

[a] *The consequences of the fraud were examined from the beginning of the last fraud year until two years after the end of the year of the last AAER related to the fraud. The occurrence of these events at the no-fraud companies was examined during the identical time period.*

[b] *There were 311 fraud companies where a similar no-fraud company could be identified.*

[c] *Tests of statistical differences were performed using Wilcoxon's signed rank test.*

[d] *Includes revocation of a firm's registration with the SEC.*

Note: A p-value that is less than 0.10 indicates that the difference between fraud and no-fraud firms was statistically significant (two-tailed).

Stock Price Reaction

To further examine the effect of the fraud on the company, we examined the stock price reaction for two different dates related to the disclosure of the alleged financial statement fraud. First, we examined the stock price reaction to the initial disclosure of the fraud. Second, we examined the stock price reaction to the initial disclosure of an investigation by the SEC or the Department of Justice.

We identified the date of the initial disclosure of an alleged financial statement fraud by searching for the initial press disclosure of a potential accounting impropriety. We took this approach since the initial press disclosure of an alleged accounting impropriety may not specifically indicate that a fraud has occurred, given that in many instances an investigation has yet to be commenced. Because that initial disclosure may or may not suggest to the markets the existence of a possible fraud, we identified a second date to measure stock market reactions. That date represents the date of the SEC's or Department of Justice's first public disclosure of an investigation.

We measured the stock reaction on these two different disclosure dates by calculating the abnormal stock returns using methodologies widely used in research to capture unique stock reactions to disclosures of new information to the capital markets. An abnormal stock return basically captures the portion of the change in stock price attributable to the company-specific news disclosed on that date and does not include normal changes for that firm's stock given changes in overall market conditions.[27]

Initial Disclosure of Potential Accounting Improprieties

For each of the two different disclosure events described above, we measured the abnormal returns over three different days. First, we measured the abnormal return on the day prior to the initial disclosure of the fraud (referred to as Day -1). Measuring stock market reactions on the day prior to the date of disclosure captures any stock market reaction to potential leakage of information in the day prior to disclosure. Next, we measured the abnormal return on the day of disclosure (referred to as Day 0). Finally, we measured the abnormal return on the day following the date of disclosure, which captures the stock price reaction on the next trading day following the date of disclosure (referred to as Day +1).

Table 29 provides information about the abnormal returns measured on each of these three days surrounding the first public disclosure of an alleged financial statement fraud. That table also shows the cumulative abnormal return for Days 0 and +1 on a combined basis, which is consistent with typical abnormal stock return research. The abnormal returns reported in Table 29 are shown in percentage form to provide an indication of the percentage change in stock price to the initial disclosure of alleged financial statement fraud.

Stock prices declined 17% on average (beyond normal market movement) across two days surrounding the initial disclosure of alleged fraud.

As expected, the average abnormal returns for each of the three days and the cumulative two days (Days 0 and +1) surrounding the first public disclosure of an alleged fraud were negative. The p-values for each day indicate that all of the negative abnormal stock returns were highly statistically significant. The mean abnormal return on Day -1 was -1.4 percent, suggesting some market reaction to potential leakage of news of an alleged fraud.

Table 29. Abnormal Stock Returns Surrounding First Public Disclosure of Potential Accounting Irregularities

	Percentage Abnormal Stock Return			
	Day -1 (n=221)[a]	Day 0 (n=213)[a]	Day +1 (n=198)[a]	Days 0 and +1 (n=215)[a]
Mean	-1.4%	-10.0%	-7.3%	-16.7%
Standard deviation	.07	.19	.17	.23
1st quartile	-2.5%	-17.2%	-12.6%	-28.6%
Median	-.5%	-3.3%	-2.2%	-11.1%
3rd quartile	1.4%	.4%	1.5%	-1.7%
t-statistic	-3.21	-23.19	-16.89	-27.25
p-value	.001	.0001	.0001	.0001

[a] *Of the 347 fraud firms, stock price information was not provided for 73 firms in the CRSP database, and we were unable to identify a unique date of the public disclosure of the potential accounting irregularity for 15 additional firms. Finally, stock price information for some of the days (-1, 0, or +1) was missing for between 38 and 61 firms, depending on the date of interest. Thus, the number of firms for each of the measurement dates differed slightly.*

Note: A p-value that is less than 0.10 indicates that the difference between fraud and no-fraud firms was statistically significant (two-tailed).

[27] We calculated abnormal returns using the Center for Research in Security Prices (CRSP) database and the Eventus program, using the market model with an equally weighted index consistent with prior research methodologies (see DeFond et al. (2007) and MacKinlay (1997)). We estimated the market model parameters using a 120-day estimation window consistent with prior research methodologies (see Palmrose et al. 2004). Given the small size of some of the fraud companies, firms were retained in the sample if 30 days or more of stock returns were available during the 120-day estimation window.

The mean stock price reaction on the day of disclosure (Day 0) jumped to -10.0 percent, followed by an additional -7.3 percent return on Day +1. The cumulative average negative abnormal return of -16.7 percent on Days 0 and +1 indicates an abnormal stock price decline of 16.7 percent over the two-day period surrounding the initial news of fraudulent financial reporting.

Initial Disclosure of SEC/Department of Justice Investigation

Table 30 provides information about the abnormal stock returns for the three days (-1, 0, and +1) surrounding the first public disclosure of a governmental investigation of the potential accounting improprieties, whether that investigation was commenced by the SEC or by the U.S. Department of Justice. The average abnormal stock return was -0.5 percent on Day -1, but this was not statistically significant, suggesting that the announcement of a governmental investigation did not leak into the market before the investigation was announced. However, the mean abnormal returns on day 0 and +1 were -4.9 percent and -2.5 percent, respectively, which were both statistically significant. Thus, the disclosure of a government investigation of alleged financial statement fraud resulted in an average abnormal stock price decline over a two-day period of 7.3 percent.

Stock prices declined 7% on average (beyond normal market movement) over the two-day period surrounding announcement of an SEC or Department of Justice investigation about alleged financial statement fraud.

It is interesting to note that these stock price declines were smaller in magnitude than those surrounding the initial press disclosure of the potential accounting improprieties. Nevertheless, the announcement of a governmental investigation, while not typically providing the initial disclosure of the potential accounting improprieties, did provide incremental information to the market. The market may have reacted to the realities of costs associated with responding to a governmental investigation and to the adverse reputational consequences for the firm.

Table 30. Abnormal Stock Returns Surrounding First Public Disclosure of SEC or Department of Justice Investigation

	Percentage Abnormal Stock Return			
	Day -1 (n=142)[a]	Day 0 (n=142)[a]	Day +1 (n=140)[a]	Days 0 and +1 (n=143)[a]
Mean	-.5%	-4.9%	-2.5%	-7.3%
Standard deviation	.09	.13	.11	.16
1st quartile	-1.5%	-8.0%	-6.3%	-13.6%
Median	-.2%	-2.2%	-1.2%	-4.0%
3rd quartile	1.6%	.5%	1.9%	-.3%
t-statistic	-1.09	-10.29	-5.39	-10.96
p-value	.28	.0001	.0001	.0001

[a] Of the 347 fraud firms, stock price information was not provided for 73 firms in the CRSP database, and we were unable to identify a unique date of the public disclosure of the SEC's or Department of Justice's investigation for 78 firms. Finally, stock price information for some of the days (-1, 0, or +1) was missing for between 53 and 56 firms, depending on the date of interest. Thus, the number of firms for each of the measurement dates differed slightly.

Note: A p-value that is less than 0.10 indicates that the difference between fraud and no-fraud firms was statistically significant (two-tailed).

Other Consequences for Individuals

In addition to SEC sanctions (e.g., fines, disgorgements, SEC officer and director bars, etc.) described earlier, individuals involved with a fraud can suffer other consequences in the labor market. We examined turnover (including the specific reason for the turnover) for the CEO, CFO, chairman of the board, and other board members. In addition, we considered criminal indictments and convictions of the CEO and CFO. We examined consequences of the fraud for individuals that occurred between the beginning of the last fraud year through two years after the year of the last AAER related to the fraud.

80% or more of CEOs and CFOs turned over following the disclosure of the alleged fraud.

Table 31 presents this information. Because we captured information about management changes and other events, it was important that we contrasted the experience of fraud firms with a similar set of no-fraud firms. Thus, Table 31 shows results for both fraud and no-fraud firms. We tracked similar consequences for no-fraud firms over the same time frame used for their related fraud firms. We were able to find similar no-fraud firms for 311 of the 347 fraud firms.

In most cases, turnover occurred for the CEO and CFO positions of companies committing fraud. Eighty-two percent of the CEOs and 80 percent of the CFOs of fraud firms experienced turnover. The comparable percentages for the no-fraud firms were 47 percent for CEOs and 49 percent for CFOs, significantly lower (p-value = 0.001). A large majority of the CEO and CFO turnover was due to resignations, although we cannot observe how many of these resignations were forced. Seven percent of the fraud companies experienced CEO terminations, while 59 percent experienced CEO resignations. In contrast, during the same time period no-fraud firms terminated two percent of their CEOs, while 21 percent of the no-fraud firm CEOs resigned. A similar pattern existed for CFO turnover at the fraud and no-fraud companies. That suggests that fraud revelations often result in significantly greater management changes.

Twenty-one percent (17 percent) of the fraud CEOs (CFOs) were criminally indicted, whereas virtually none of the no-fraud CEOs or CFOs was criminally indicated over the same time periods (statistically significant (p-value = 0.001)). For fraud firms, 64 percent of the CEOs criminally indicted were convicted (41/64), whereas 75 percent of the CFOs criminally indicted were convicted (39/52). This difference likely reflects the greater difficulty that CFOs have in denying that they had any knowledge of the fraud given the CFO's responsibility for the firm's finances.

For fraud firms, approximately two-thirds of board chairs left the board, whereas only 25 percent of board chairs left the boards of no-fraud firms, which is significantly lower (p-value = 0.001). In addition, 68 percent of fraud firms experienced turnover of at least one other board member as compared to 40 percent of no-fraud firms (p-value = 0.001). As was the case with CEO and CFO turnover, resignation was the most common reason given for the departure. Fifteen percent (32 of 211 instances) of the board chair turnover at fraud firms was due to the board chair being terminated, whereas only 11 percent (9 of 79 instances) of the board chair turnover at no-fraud firms was due to a termination. Also, if there was turnover of the CEO, CFO, or board chair, the board chair was most likely to be fired. Turnover of other board members at both fraud and no-fraud firms was overwhelmingly due to resignations, but terminations of other board members occurred in six percent of the fraud firms. We identified only one instance where a non-chair board member at a no-fraud firm was terminated.

Approximately 20% of CEOs and CFOs of fraud companies were criminally indicted, and about two-thirds of those indictments ultimately led to criminal convictions.

Table 31. Consequences to Individuals
(n = 311)

Subsequent Consequences[a]	Number of Fraud Firms Affected	Percentage of Fraud Firms Affected	Number of No-Fraud Firms Affected	Percentage of No-Fraud Firms Affected	p-value[b]
CEO turnover:	255	82%	147	47%	.001
Firing/dismissal	23	7%	5	2%	
Resignation	185	59%	66	21%	
Retirement	17	6%	24	8%	
Another position	14	5%	17	5%	
Other	16	5%	35	11%	
CFO turnover:	250	80%	153	49%	.001
Firing/dismissal	25	8%	3	1%	
Resignation	157	51%	64	21%	
Retirement	14	4%	18	6%	
Another position	39	12%	55	18%	
Other	15	5%	13	4%	
CEO criminal indictment	64	21%	1	< 1%	.001
CEO criminal conviction	41	13%	1	< 1%	.010
CFO criminal indictment	52	17%	1	< 1%	.001
CFO criminal conviction	39	13%	0	0%	.010
Chairman of board turnover:	211	68%	79	25%	.001
Firing/dismissal	32	10%	9	3%	
Resignation	147	47%	48	15%	
Retirement	16	5%	12	4%	
Another position	4	1%	0	0%	
Other	12	4%	10	3%	
Other board turnover:	212	68%	123	40%	.001
Firing/dismissal	19	6%	1	< 1%	
Resignation	177	57%	103	33%	
Retirement	4	1%	7	2%	
Another position	2	1%	5	2%	
Other	10	3%	7	2%	

[a] *The consequences of the fraud for individuals were examined from the beginning of the last fraud year until two years after the year of the last AAER related to the fraud. The occurrence of these events for individuals at the no-fraud firms was examined during the identical time period.*

[b] *Tests of statistical significance were performed using the Wilcoxon's signed rank test.*

Note: A p-value that is less than 0.10 indicates that the difference between fraud and no-fraud firms was statistically significant (two-tailed).

IV. Conclusion

We believe that our analysis of fraudulent financial reporting from 1998-2007 reveals several key messages. First, the financial statement fraud problem still exists and warrants continued attention. The SEC alleged that 347 public companies committed fraud over the ten-year period 1998-2007. The magnitude of individual fraud cases and the size of fraud companies both increased markedly from COSO's 1999 report. The major accounting scandals of the early 2000s involved larger frauds and larger companies, which contributed to the nearly $120 billion in cumulative misstatement or misappropriation across all frauds in the ten-year period. Because the number of frauds examined in this study involving financial reporting periods after the passage of SOX is very limited, further research is needed to assess the effects of SOX in addressing fraud.

Second, the SEC continues to name individuals in the C-suite for some alleged involvement in the fraud, even more so than in the past. During 1998-2007, the CEO and/or CFO were named in an AAER in nearly 90 percent of the cases. Boards, auditors, and regulators need to seek additional tools to assess management integrity and susceptibility to fraud pressures. Research about leadership and organizational behavior may help to provide insights about potential drivers of financial statement fraud.

Third, revenue fraud continues to emerge as the leading type of fraud, now accounting for over 60 percent of SEC fraud cases. Additional research into revenue fraud methods, especially industry-specific studies, may reveal new ways to address this risk area.

Fourth, board governance characteristics often do not differ meaningfully between fraud and no-fraud firms. These characteristics have been the focus of recent regulation, thus reducing or even eliminating previous fraud/no-fraud differences. Future research on governance processes and the interaction of various governance mechanisms may be needed to identify less-observable governance differences associated with fraudulent financial reporting.

Fifth, fraud companies are twice as likely to change auditors as no-fraud firms between the last clean financial statements and the last fraudulent financial statements. More research is needed to fully understand the relation between auditor change and fraudulent financial reporting.

Finally, the consequences of fraud are severe for individuals and companies. Individuals may face civil fines, SEC bars, disgorgement, and criminal prosecution. Fraud companies experience significant negative abnormal stock price declines, and they face bankruptcy, delisting, and material asset sales at much higher rates than do no-fraud firms.

Call for Further Research and Analysis

COSO sponsored this study, *Fraudulent Financial Reporting: 1998-2007*, to provide a comprehensive analysis of fraudulent financial reporting occurrences investigated by the U.S. Securities and Exchange Commission between January 1998 and December 2007. This study updates our understanding of fraudulent financial reporting since COSO's 1999 issuance of *Fraudulent Financial Reporting: 1987-1997*.

COSO's mission is to provide thought leadership through the development of comprehensive frameworks, guidance, and research on enterprise risk management, internal control, and fraud deterrence. COSO's efforts are designed to improve organizational performance and governance and to reduce the extent of fraud in organizations.

COSO hopes that those involved in financial reporting will carefully consider the results reported in this study and recommit their efforts to improve the prevention, deterrence, and detection of fraudulent financial reporting. While several insights from this study are discussed within this document, more research is needed to better understand fraudulent financial reporting. COSO encourages other thought leaders to creatively explore new and different ways to reduce occurrences of fraudulent financial reporting.

COSO, 2010

V. Authors

Mark S. Beasley is the Deloitte Professor of Enterprise Risk Management and Professor of Accounting at North Carolina State University. He is the Director of NC State's Enterprise Risk Management (ERM) Initiative, which provides thought leadership about ERM practices and their integration with strategy and corporate governance. Mark currently is serving on the board for the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Mark has previously served as President of the American Accounting Association's Auditing Section and on several national task forces and working groups, including the Auditing Standards Board SAS No. 99 Fraud Task Force. His research has appeared in such journals as *The Accounting Review, Journal of Accounting Research, Contemporary Accounting Research, Auditing: A Journal of Practice & Theory,* and *Accounting Horizons*. He is a frequent speaker at national and international conferences on ERM, internal controls, and corporate governance, including audit committee practices.

Mark can be reached at: **mark_beasley@ncsu.edu**.

Joseph V. Carcello is the Ernst & Young Professor and co-founder and Director of Research at the University of Tennessee's Corporate Governance Center. He has published in such journals as *The Accounting Review, Journal of Accounting Research, Contemporary Accounting Research, Auditing: A Journal of Practice & Theory,* and *Accounting Horizons*. Joe is a member of the Public Company Accounting Oversight Board's (PCAOB's) Investor Advisory Group, he served on the PCAOB's Standing Advisory Group, he testified before the U.S. Treasury Department Advisory Committee on the Auditing Profession, and he served on COSO's Small Business Control Guidance Advisory Group Task Force. Joe has served as Vice President – Finance of the American Accounting Association, and as President of the Auditing Section of the AAA. He has served as an expert witness in cases involving fraudulent financial reporting for the U.S. Securities and Exchange Commission, and as an expert in evaluating corporate governance reforms instituted as part of legal settlements of shareholder claims in federal and state courts.

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Authors - continued

Dana R. Hermanson is Dinos Eminent Scholar Chair of Private Enterprise, Professor of Accounting, and Director of Research in the Corporate Governance Center at Kennesaw State University. Among the most prolific researchers in accounting, he has published in such journals as *Contemporary Accounting Research, Auditing: A Journal of Practice & Theory, Journal of Accounting and Public Policy, Journal of Accounting Literature, Accounting Horizons, Behavioral Research in Accounting, Journal of Information Systems,* and *Issues in Accounting Education*. Dana is co-editor of *Accounting Horizons* and was founding co-editor of *Current Issues in Auditing*. He and his co-authors received the 2008 Deloitte/AAA Wildman Medal, which recognizes research judged "to have made or be likely to make the most significant contribution to the advancement of the public practice of accountancy." Dana was a member of the NACD Blue Ribbon Commission on Audit Committees, and his work has appeared in such outlets as *The Wall Street Journal* and *BusinessWeek*.

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Terry L. Neal is the Dennis Hendrix Professor of Accounting in the Department of Accounting and Information Management at the University of Tennessee and a Research Fellow at the University of Tennessee's Corporate Governance Center. He also serves as the director of the Ph.D. program in Accounting. Terry's research has been published in *The Accounting Review, Contemporary Accounting Research, Auditing: A Journal of Practice & Theory, Journal of Accounting and Public Policy, Accounting Horizons, The International Journal of Accounting,* and *Corporate Governance: an international review*. He currently serves or has served on the editorial boards of *The Accounting Review, Auditing: A Journal of Practice & Theory, Accounting Horizons,* and *Current Issues in Auditing*. Terry also has served as an ad-hoc reviewer for several other journals including *Contemporary Accounting Research, Journal of Accounting and Public Policy, Journal of Accounting Literature,* and *Issues in Accounting Education.*

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Note: Beasley, Carcello, and Hermanson are co-authors of the preceding COSO-sponsored study, *Fraudulent Financial Reporting: 1987-1997, An Analysis of U.S. Public Companies*.

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Notes

COSO

Committee of Sponsoring Organizations
of the Treadway Commission

www.coso.org

FRAUDULENT FINANCIAL REPORTING 1998-2007

An Analysis of U.S. Public Companies

COSO

Committee of Sponsoring Organizations of the Treadway Commission

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Attachment 4a

State of California
Department of Consumer Affairs

California Board of Accountancy
2000 Evergreen Street, Suite 250
Sacramento, CA 95815-3832

M e m o r a n d u m

<u>ECC Agenda Item V.</u>
January 26, 2011

To : ECC Members

Date : January 13, 2010

Telephone : (916) 561-4310
Facsimile : (916) 263-3676
E-mail : dfranzella@cba.ca.gov

From : Dominic Franzella, Manager
License Renewal & Continuing Competency Unit

Subject : Research Materials Provided by ECC Members and Information on Ethics Survey

On January 11, 2011, Deanne Pearce, Licensing Division Chief, sent an e-mail communication to all Ethics Curriculum Committee (ECC) members regarding a survey presently being conducted on the 10 units of ethics study which will be required for CPA licensure beginning January 1, 2014. Staff have contacted the organizers of the survey requesting the survey questions and any results that are available, so that they may be shared with ECC members at its upcoming meeting. Should any information be received, we will provide it to members either electronically or hand carry it to the meeting.

State of California
Department of Consumer Affairs

Attachment 5

California Board of Accountancy
2000 Evergreen Street, Suite 250
Sacramento, CA 95815-3832

M e m o r a n d u m

<u>ECC Agenda Item VI.</u>
January 26, 2011

To : ECC Members

Date : December 20, 2010

Telephone : (916) 561-4310
Facsimile : (916) 263-3676
E-mail : dfranzella@cba.ca.gov

From : Dominic Franzella, Manager
License Renewal & Continuing Competency Unit

Subject : Ethics Study Required by Business and Professions Code Section 5093

This memorandum is being provided to supply information to Ethics Curriculum Committee (ECC) members on the following topics:

1. Further Background Regarding Senate Bill (SB) 819

2. Impact of Recommending Less Than 10 Units of Ethics Study

3. Next Steps in Recommending Ethics Study Guidelines to the California Board of Accountancy (CBA)

Further Background Regarding SB 819

At the request of ECC Chair Donald Driftmier, CPA, in early December, staff sent letters (**Attachment #1**) to the California Society of Certified Public Accountants (CalCPA) and Center for Public Interest Law (CPIL) requesting further background on SB 819. Specifically, staff posed the following two questions:

1. How did the Legislature come to specify the total number of units of ethics study at a minimum of 10, as opposed to setting it at a lower or higher number?

2. What discussions occurred regarding the number of possible courses available to meet the requirement?

Provided in **Attachments #2 and #3** respectively are the responses received from CPIL and CalCPA. After receiving CPIL's letter (dated December 15, 2010), Mr. Howard requested that three news articles be included as part of his letter to further underpin his remarks.

Impact of Recommending Less Than 10 Units of Ethics Study

At the September 21, 2010 ECC meeting considerable discussion occurred regarding the directive the CBA placed on the ECC requiring the committee to determine the appropriateness and feasibility for obtaining 10 units of ethics study. Various members noted that the law as presently written does not allow for anything less than a minimum of 10 units to be recommended to the CBA. ECC Chair Donald Driftmier, CPA, requested that staff provide information on the impact should the ECC recommend to the CBA anything less than 10 units of ethics study.

Business and Professions Code Section 5094.6(a) states, "the [ECC] shall recommend to the [CBA] ethics study guidelines consisting of no less than 10 semester units to be included as part of the education required under Section 5093." As some members clearly noted at the prior meeting, the language in present law offers no latitude for the ECC to provide the CBA anything less than 10 units; however, it does not prohibit the ECC, should it believe necessary, to recommend to the CBA more than 10 units. Therefore, any recommendation that comes in at less than 10 units would require a legislative change.

Next Steps in Recommending Ethics Study Guidelines to the CBA

The materials provided for this meeting have supplied members with increased information on SB 819, applicants applying for California CPA licensure, where ethics is presently available at various California colleges and universities, and where new practitioners could benefit from with increased ethics. In addition, SB 819 provides the following definition for the ethics study guidelines:

> [A] program of learning that provides students with a framework of ethical reasoning, professional values, and attitudes for exercising professional skepticism and other behavior that is in the best interest of the investing and consuming public and the profession. At a minimum this includes academic work or independent study and shall include a foundation for ethical reasoning and the core values of integrity, objectivity, and independence consistent with the International Education Standards-4 of the International Accountants Education Standards Board, the International Federation of Accountants Code of Ethics, and the American Institute of Certified Public Accountants Code of Professional Conduct.[1]

For future meetings staff believe it is important to identify those topics and issues members wish to discuss that will begin establishing a framework for the ethics study. Topics may include:

- Further discussion regarding ethics embedded in various accounting and business courses. As evidenced by the research conducted and provided by

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[1] These materials are included in the ECC Reference Materials provided at the September 21, 2010 meeting.

ECC members, courses exist where ethics is not part of the course title but embedded in the course materials being covered. Does the ECC wish to allow for portions of courses to count towards the 10 units of ethics study? If so, what factors would go into determining how many units of a course could qualify? How would staff know to apply a portion of a course towards ethics-based study on a single title on a transcript?

- Should the ECC prescribe a specified number of units in a specific area of ethics study (*e.g.* business ethics, personal ethics, or philosophy of ethics)?

- Should some portion of ethics study be completed at an upper division level?

The above list represents some initial topics/issues that could be addressed at future ECC meetings. It is not an exhaustive list, but is being provided to facilitate discussion. Staff would greatly value any additional topics/issues that members believe important as the committee continues discussions on the ethics study guidelines.

Attachments

CALIFORNIA BOARD OF ACCOUNTANCY

DEPARTMENT OF CONSUMER AFFAIRS
CALIFORNIA BOARD OF ACCOUNTANCY
2000 EVERGREEN STREET, SUITE 250
SACRAMENTO, CA 95815-3832
TELEPHONE: (916) 263-3680
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WEB ADDRESS: *http://www.cba.ca.gov*

November 30, 2010

Attachment #1

Bruce Allen
California Society of CPAs
1201 K Street, Suite 1000
Sacramento, CA 95814

Dear Mr. Allen:

The Ethics Curriculum Committee (ECC), tasked with supplying guidelines to the California Board of Accountancy (CBA) on the 10 units of ethics study required as a result of Senate Bill (SB) 819, held its first meeting on September 21, 2010. At this meeting, CBA staff provided ECC members with an overview of licensure requirements and SB 819.

As the ECC continues toward developing the ethics study guidelines, CBA staff would like to provide ECC members with additional background on how the Legislature came to the decision to require the 10 units of ethics study. As the California Society of CPAs and the Center for Public Interest Law were instrumental in working with the Legislature in developing the language affecting the CBA in SB 819, we are requesting that each organization provide information on the questions outlined below.

- How did the Legislature come to specify the total number of units of ethics study at minimum of 10, as opposed to setting it at lower or higher number?

- What discussions occurred regarding the number of possible courses available to meet the requirement?

As the next ECC meeting is scheduled for January 26, 2011 in Irvine, California, CBA staff would appreciate responses to these questions by December 15, 2010. If you would prefer, CBA staff is open to having a conference call regarding the above questions. Should you wish to discuss the questions via a conference call, please contact Cindi Fuller, Licensing Coordinator, by telephone at (916) 561-4367 or by e-mail at cfuller@cba.ca.gov.

As an important stakeholder, we value your input and look forward to working with you. Should you have any questions, please do not hesitate to contact Ms. Fuller at the contact information above, or Dominic Franzella, Licensing Manager, by telephone at (916) 561-4310 or by e-mail at dfranzella@cba.ca.gov.

Sincerely,

Patti Bowers, Executive Officer
California Board of Accountancy

c: Donald Driftmier, CPA, ECC Chair
ECC Members
Jeannie Tindel, CalCPA
Julianne D’Angelo Fellmeth, CPIL
Ed Howard, CPIL

CALIFORNIA BOARD OF ACCOUNTANCY

DEPARTMENT OF CONSUMER AFFAIRS
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November 30, 2010

Julianne D'Angelo Fellmeth, CPIL Administrative Director
Center for Public Interest Law
University of San Diego School of Law
5998 Alcala Park
San Diego, CA 92110

Dear Ms. Fellmeth:

The Ethics Curriculum Committee (ECC), tasked with supplying guidelines to the California Board of Accountancy (CBA) on the 10 units of ethics study required as a result of Senate Bill (SB) 819, held its first meeting on September 21, 2010. At this meeting, CBA staff provided ECC members with an overview of licensure requirements and SB 819.

As the ECC continues toward developing the ethics study guidelines, CBA staff would like to provide ECC members with additional background on how the Legislature came to the decision to require the 10 units of ethics study. As the Center for Public Interest Law and the California Society of CPAs were instrumental in working with the Legislature in developing the language affecting the CBA in SB 819, we are requesting that each organization provide information on the questions outlined below.

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As an important stakeholder, we value your input and look forward to working with you. Should you have any questions, please do not hesitate to contact Ms. Fuller at the contact information above, or Dominic Franzella, Licensing Manager, by telephone at (916) 561-4310 or by e-mail at dfranzella@cba.ca.gov.

Sincerely,

Patti Bowers, Executive Officer
California Board of Accountancy

c: Donald Driftmier, CPA, ECC Chair
ECC Members
Ed Howard, CPIL
Bruce Allen, CalCPA
Jeannie Tindel, CalCPA

University of San Diego

Attachment #2

December 15, 2010

Patti Bowers, Executive Officer
California Board of Accountancy
2000 Evergreen Street, Suite 250
Sacramento, California 95815-3832

Dear Ms. Bowers:

You have written asking certain questions of CPIL about the required ten units of ethics education.

CPIL is a nonprofit, nonpartisan academic and advocacy organization based at the University of San Diego School of Law. For twenty-seven years, CPIL has studied occupational licensing and monitored California agencies that regulate businesses, trades, and professions, including the California Board of Accountancy. To our knowledge, no other consumer group in the nation monitors the accounting profession on an ongoing basis.

CPIL's expertise has long been relied upon by the Legislature, the executive branch, and the courts where the regulation of licensed professions is concerned. For example, after numerous reports of problems at the Medical Board were published in 2002, the Department of Consumer Affairs named CPIL Administrative Director Julie D'Angelo Fellmeth as its Enforcement Monitor, charged over a two-year period with an in-depth investigation and review of all of the Medical Board's practices, policies, and operations. Two major pieces of reform legislation were enacted mirroring the Monitor's many recommendations. CPIL staff have also played key, outside monitoring roles at the State Bar and the Contractors' State Licensing Board.

While it must be underscored that the overwhelming majority of CPA auditors perform their functions admirably and honestly, the last two decades have seen some catastrophic ethical lapses with life-destroying consequences for millions of investors and the world economy. As two CPA educators observed:

> The accounting process and the information it provides is critical to business. The technology boom and bust of the late 1990s and the current subprime credit crisis are clear evidence of the importance of fundamental accounting information, concepts, and their professional implementation and monitoring. **The blatant disregard of basic accounting and auditing concepts was evident in the subprime sector. The failure of lenders and their auditors to perform a simple verification of borrowers' income and credit histories is a contributing cause of this ongoing crisis.**

> There is significant blame to be shared by many other parties, including legislators, regulators, financial firms, lawyers, bond rating companies, realtors, mortgage brokers, and homeowners. The reputation of the accounting profession depends to a large degree on the quality of the critical attest function it provides to the public. **Thus, more than other parties, auditors must learn from these repeated and seemingly ongoing professional failures. Poor loan underwriting practices should have been easily identified in even the most basic of audits and then should have been adequately addressed.**[1]

Some CPA educators have long advocated for more ethics in CPA education. Consider this example from the January 2007 *CPA Journal* (emphases supplied):

> "**Accounting Ethics Courses: Do They Work?**
>
> *By David F. Bean and Richard A. Bernardi*
>
> Those opposed to adding a required ethics course in accounting have stated that there is no proof that such a course would result in more-ethical behavior. In the absence of such proof, the proposal to require ethics education in the accounting curriculum is dismissed by supposedly unbiased and learned opponents. **The authors, however, and many others, are deeply concerned that ethics courses are challenged while the place of other courses in the curriculum goes unexamined**. Curriculum review should be an ongoing process at institutions of higher education. If one is concerned with outcomes assessment, then the burden of proof should be applied equally to all accounting courses, not just ethics. Is this double standard a positive contribution of academia to the accounting profession?
>
> Consider an outcomes assessment of courses after Enron and WorldCom. **Besides being ethical failures, these scandals also represent failures of the accounting curriculum, if one uses the proposed measurement standard suggested for ethics. The failed audits of Enron and WorldCom not only challenge the effectiveness of auditing courses, they also reflect poorly on what is being taught in intermediate accounting courses. The WorldCom fraud goes to the heart of the introductory financial accounting course; had its auditors heeded the definition of assets as items having future value and expenses as items having no future value, the WorldCom audit would not have failed.** Viewed in such a light, even an introductory course would not receive a positive outcome assessment.
>
> Kohlberg's Moral Development

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[1] *"Accounting Implications in the Subprime Meltdown," CPA Journal* (December, 2008), www.allbusiness.com/trends-events/audits/11729624-1.html, -- emphases supplied

William M. VanDenburgh, PhD, Robinson, Farmer, Cox Faculty Fellow Assistant Professor of Accounting, James Madison University, Philip J. Harmelink, PhD, CPA, Professor of Accounting, University of New Orleans.

One of the theories covered in most introductory ethics courses is the Kohlberg model of moral development (Lawrence Kohlberg, "Stages and Sequences: the Cognitive Development Approach to Socialization," *Handbook of Socialization Theory and Research*, edited by D. Goslin, 1969). Kohlberg describes moral development as a series of six progressive stages that describe the logic used in making decisions in situations involving ethical components. At stage two, an individual uses a cost/benefit relationship that focuses on oneself. In stage three, an individual focuses on oneself and one's close circle of friends, maximizing benefits after carefully considering the costs involved. In stage four, the reasoning process is focused on following the rules of the individual's society (or profession). In this stage, an individual is concerned with following the rules as the price of membership in the society or profession (i.e., a rules-based approach). Finally, at stages five and six, the individual includes considerations of what one should do in a situation free of the constraints of the lower-stage levels (i.e., a concepts-based approach).

In Kohlberg's model, an individual's level of moral development is at a distinct level at any given point. While reasoning is primarily at one dominant stage, others maintain that some decisions can also be based on reasoning using higher- or lower-stage level considerations (James R. Rest, *Moral Development: Advances in Research and Theory*, 1986). Rest maintains that individuals have different levels of sensitivity to ethical situations. The most frequently used measure of one's moral development is Rest's Defining Issues Test, which measures an individual's level of moral development (James R. Rest, *Defining Issues Test*, 1979). Scoring on this test is based on the proportion of stage five and stage six considerations used in one's decision process. Higher scores on the Defining Issues Test reflect reasoning about what should be done rather than rigidly following a set of rules (stage four) or looking out for oneself or one's friends (stages two and three).

Following the Rules

The Kohlberg-Rest model has been used in numerous accounting ethics studies, **which note that accounting students and practitioners score lower on Rest's Defining Issues Test than does the general population of students and college graduates.** Many researchers speculate that this phenomenon is the result of being part of a profession that inculcates a "following the rules" mentality (i.e., stage four). Following the rules is a lower level of ethical reasoning that the profession has used as a comfortable excuse: "We did everything we were required to do."

Unfortunately, recent audit failures indicate that everyone should be more sensitive to the ethical implications embedded in the audit environment. For example, the leadership of Deloitte & Touche believes that the accounting profession has "always strived to 'follow the rules.' But in the wake of scandals and the loss of investor confidence, we obviously must do more to restore public trust" (William G. Parrett, "Globalization's Next Frontier: Principled Codes of Conduct That Bolster the Rule of Law," speech to International Center for Corporate Accountability, May 14, 2004). As Parrett suggests, the profession must consider what we should be doing rather than just meeting basic requirements. This is the challenge of an accounting ethics course:

Students must be exposed to the real challenges of auditing and the need to maintain a critical mentality when examining a client's data.

Ethical Sensitivity and Auditing

Researcher and coauthor of this article Richard A. Bernardi examined fraud detection using a sample of 342 audit seniors and 152 audit managers from five of the former Big Six firms (Richard A. Bernardi, "Fraud Detection: The Effect of Client Integrity and Competence and Auditor Cognitive Style," *Auditing: A Journal of Practice & Theory*, 1994). One-third of Bernardi's sample was told they were auditing a high-integrity client, one-third a low-integrity client, and the remaining third was not provided with any explicit integrity information; all other data contained in the work papers were identical. Not surprisingly, the study found that managers detected the embedded fraud at a higher rate than did seniors (5% and 42%, respectively), an experience effect. Bernardi also found that managers who scored higher on Rest's measure of ethical sensitivity detected fraud at a higher rate when provided with client integrity data, either high or low, than did the managers who scored lower on Rest's measure (75% and 47%, respectively). Audit managers in the control group who scored high on Rest's measure but were not provided with client integrity data fared no better than did managers who scored lower on Rest's metric (54% and 56%, respectively).

Further research found that managers used a more conservative estimate of materiality as their scores on Rest's measure of ethical sensitivity increased (Richard A. Bernardi and Donald F. Arnold, "The Influence of Client Integrity and Competence and Auditor Characteristics on Materiality Estimates," *The Irish Accounting Review*, 1994). Auditors who scored higher on Rest's measure also were more likely to disclose sensitive findings even when management threatened retaliation (Donald F. Arnold and Lawrence A. Ponemon, "Internal Auditors' Perceptions of Whistle-Blowing and the Influence of Moral Reasoning," *A Journal of Practice & Theory*, 1991) and were less likely to underreport billable hours (Lawrence A. Ponemon, "Auditor Underreporting of Time and Moral Reasoning: An Experimental-Lab Study," *Contemporary Accounting Research*, 1992). **In sum, the existing research demonstrates the benefits of being more sensitive to ethical issues in an auditing context.**

Accountants' Level of Ethical Sensitivity

Having demonstrated the importance of increased ethical sensitivity, it is disturbing that, in an analysis of prior studies, **the authors found that accounting majors' scores on Rest's measure are consistently below that of the general population throughout and after college** (Richard A. Bernardi and David F. Bean, "Establishing a Standardization Sample for Accounting Students' DIT Scores," presented at the Northeast Region of the American Accounting Association's Annual Conference, Portsmouth, N.H., 2006). Another study provided data demonstrating that an accounting ethics course can increase a participant's ethical sensitivity as measured by Rest's Defining Issues Test (Mary Beth Armstrong, "Ethics and Professionalism in Accounting Education: A Sample Course," *Journal of Accounting Education*, 1993). Armstrong tested all students at the beginning and the end of the semester (i.e., pretest and post-test methodology). **Her data indicated that those students who had already taken a general ethics course and who also took the ethics and professionalism course scored significantly higher on Rest's Defining Issues Test. An increase in one's ethical sensitivity is thus the result of a synergy of academic experiences in ethics.**

Armstrong's recommendation closely approximates the National Association of State Boards of Accountancy's (NASBA) original **proposal that ethics in the accounting curriculum should include a triad of ethics instruction comprised of an ethics philosophy course, ethical coursework in the accounting curriculum, and a capstone ethics and professionalism course.** The authors believe that the research needed to show an association between an ethics course (Armstrong) and outcomes assessment in an audit environment (Bernardi) has already been done. Why have the profession and academia chosen to ignore these and many other ethics research studies when debating whether an ethics course should be included in the accounting curriculum?

NASBA's Proposal

NASBA's original proposal for a three-course ethics sequence parallels the current accounting course sequence: two introductory courses prior to two intermediate accounting courses, followed by advanced accounting. The initial course should be taught in the liberal arts context and cover the spectrum of theories in ethics. What is questionable is whether all business majors should be required to take a business ethics course as covering ethics "across the curriculum" [Association for the Advancement of Collegiate Schools of Business (AACSB), *Ethics Education in Business Schools*, 2004]. Finally, a discipline-specific accounting ethics course taken during the same semester that a student takes auditing would provide a synergy not in the current curriculum.

This three-course sequence should provide the profession with auditors who are more ethically sensitive. Given the number of courses that must be taken to qualify for the CPA exam, it is inconceivable that every one would be considered more important to those entering the profession than an accounting ethics course.

The Need for the Ethics Course

Accounting scandals in large companies and organizations generate notoriety and often result in adverse publicity for the accounting profession. Many practitioners can relate their own stories involving small and family businesses, and although the economic impact may not have been as great, the personal devastations suffered were just as severe.

Certainly no single ethics course or group of ethics courses can guarantee that students will always behave and act ethically. Similarly, there is no guarantee that those taking accounting courses will always properly account for a given transaction. An honest assessment of the errors and omissions that experienced professionals encounter when reviewing the work of less-experienced colleagues clearly demonstrates that having an accounting degree does not guarantee accurate or proper accounting. Individuals would probably concur, however, that the probability of correct and ethical choices increases with increased education in these particular subject areas. **An accounting ethics course should lessen the frequency and severity of ethical lapses in the profession.**

Organizations and reporting requirements evolve to address the increasing complexity of events and transactions. There is a need for ethics education of professional accountants that enables them to grow beyond the simplistic rules of right and wrong that were learned in childhood. Accountants need more-advanced tools to fulfill their societal obligations in this increasingly complex environment with its many shades of gray.

Ethics is of primary importance to the accounting profession, and the profession clearly has the right, if not the obligation, to require an accounting ethics course as a condition of admittance. The academic community is entitled to determine the quantity and nature of accounting courses that are offered. Each institution of higher education, however, has the prerogative to determine its curriculum, and there a collective agreement is not required. Accounting students can study accounting ethics either at the institution they are attending or, if not offered at their institution, at a different institution. The authors believe that if academia continues to collectively oppose a course in accounting ethics, it would be in the accounting profession's best interest to create and offer its own accounting ethics course as a precondition of entry to the profession."

Current law for all of these reasons requires ethics education in California.

Moreover, this law embraces an historic compromise between consumers and the profession to fill up the so-called "hollow" 30 with coursework directly traceable to meaningful outcomes for consumers. The law provides terrific flexibility to the Committee as to how to calculate the ten units and what academic or practical work experience satisfies the requirement. Indeed, that the Legislature delegated the task to the Committee and the Board demonstrates its willingness to be practical-minded.

Self-evidently, the ten units to require a significant amount of ethical training. While it may be alluring to debate the wisdom of requiring ethics and the number of specific units required, respectfully, the Legislature has already set the policy in both of these matters.

CPIL's commitment to the profession was and remains that should the ten units prove simply unworkable notwithstanding the flexibility in current law specifically included at the behest of the profession to ease implementation, CPIL in good faith would be willing to entertain an alternative number of units. But practical unworkability is not the same thing as a simple disagreement with the number of units or the policy underpinning the number and, respectfully, the burden is on the Committee to make a record that differentiates clearly between the two.

We therefore hope that the Committee that the Legislature charged with implementing the ten units will apply all of its energies toward the urgent task of implementation.

As for the number of possible courses to satisfy the requirement, the relevant discussion was about making the law flexible enough so that, for example, portions of courses or independent study could possibly satisfy the requirement.

I am uncertain if I can attend the next Committee meeting on the 26th. I would welcome the chance to speak to any individual Committee members to answer any questions they may have.

Sincerely,

Ed Howard, Senior Counsel, CPIL

March 14, 2010

Auditor Could Face Liability in Lehman Case

By MICHAEL J. de la MERCED

Lehman Brothers may have collapsed a year and a half ago, but fallout from its demise has created a potential legal liability for its former accounting firm, Ernst & Young.

A 2,200-page report by a court-appointed examiner, Anton R. Valukas, on Lehman's collapse has plenty of criticism for various players involved with the investment bank. But some of his harshest words are reserved for Ernst & Young and the accounting maneuvers it permitted.

Mr. Valukas writes that he found enough evidence to support at least three claims against the accounting firm for not looking more closely into Lehman's use of questionable accounting. Lehman used the tactics, known inside the bank as Repo 105, to hide as much as $50 billion off its balance sheet to temporarily reduce its debt levels.

His report concludes that sufficient evidence exists to bring claims of malpractice against the accounting firm on the grounds of failing to disclose or investigate the technique. Legal and accounting experts say that Ernst & Young could now face potentially damaging civil litigation by private plaintiffs or the Securities and Exchange Commission — or even criminal charges by the Justice Department.

The examiner's report has again led financial experts to question how accounting firms can fail to closely scrutinize their clients' bookkeeping. Ernst & Young's actions came after the passage of laws like the Sarbanes-Oxley Act of 2002 in the wake of the Enron and WorldCom accounting scandals and the collapse of Arthur Andersen for its role in those frauds.

Ernst & Young itself paid an $8.5 million fine to the S.E.C. in December for its role in allowing another client, Bally Total Fitness, to avoid restating its earnings in 2002 when accounting rules changed.

Charlie Perkins, an Ernst & Young spokesman, said in a statement that the firm's last full audit of Lehman was for the 2007 fiscal year and that it stood by its results. "After an exhaustive investigation the examiner made no findings in his report that Lehman's assets or liabilities were improperly valued or accounted for incorrectly in Lehman's November 30, 2007 financial statements," he said.

"One thing Sarbanes-Oxley reminded us of is that technical compliance isn't enough," said Lawrence A. Cunningham, a law professor at George Washington University. "Accounting firms need to be sitting back the whole time and thinking, is this a fair presentation?"

He added that any large judgment against the accounting firm, let alone tough regulatory action, could prove enormously damaging in terms of both money and future business.

"If a breach of liability is established here, this could be disastrous in my view," he said.

According to the report, Ernst first learned of Lehman's use of Repo 105 in 2001, shortly after it was designed. Partners of the accounting firm told Mr. Valukas that at the time, Ernst had not signed off on Repo 105 on anything more than a "theoretical" level, and gave approval only of Lehman's internal policy regarding the practice.

At no point did Ernst review the approval letters by the British law firm Linklaters, the only outside legal counsel Lehman could find that would sign off on the practice.

By 2007, Mr. Valukas writes, Ernst was aware of $29 billion in Repo 105 transactions. While Ernst knew of the practice for years, the issue of Repo 105 was thrust to the fore in spring 2008. On June 12, two Ernst partners, William Schlich and Hillary Hansen, met with Matthew Lee, a Lehman executive who had written senior management a letter to complain of what he saw as accounting improprieties.

The firm was "also dealing with a whistle-blower letter, that is on its face pretty ugly and will take us a significant amount of time to get through," Mr. Schlich wrote in a June 5 e-mail message to colleagues, the examiner's report said.

At that meeting, Mr. Lee informed the two accountants that Lehman was using Repo 105 to move $50 billion of the firm's assets off its balance sheet at the quarter's end to make its debt levels look smaller. The firm reassumed those assets about a week later.

But the next day, Ernst spoke to Lehman's audit committee — but did not disclose Mr. Lee's allegations on Repo 105.

Mr. Perkins said Ernst never concluded its review of Mr. Lee's claims because Lehman filed for bankruptcy before the firm could finish its audit.

L.A. NOW
SOUTHERN CALIFORNIA — THIS JUST IN

From the metro staff of the Los Angeles Times and...

KTLA 5 NEWS FOX 5 SAN DIEGO

Bell's auditors should have spotted most of the alleged corruption, state controller finds

December 21, 2010 | 2:58 pm

The state controller's office Tuesday issued a scathing review of the work performed by Bell's outside auditor, saying that most of the alleged corruption in the Los Angeles County city would have been identified earlier had the firm done its job.

The long-awaited audit said Mayer Hoffman McCann repeatedly failed to follow basic fieldwork practices when it audited the city's books.

Mayer Hoffman McCann "appears to have been a rubber stamp rather than a responsible auditor committed to providing the public with the transparency and accountability that could have prevented the mismanagement of the city's finances by Bell officials," state Controller John Chiang said in a news release.

The 153-page review said that Mayer Hoffman did not look hard enough for documentation and evidence to support city records.

Chiang's office said it was forwarding the review to the state Board of Accountancy for possible disciplinary action.

The review notes that the auditing firm disputes the findings.

Chiang's report is the latest critical look at a city that has been enveloped by scandal since The Times revealed the enormous salaries paid to administrators and part-time politicians in one of Los Angeles County's poorest cities.

Bell is now teetering on the edge of insolvency and may have to take drastic steps such as disbanding its police department to balance the city's finances. The Times has reported that Rizzo also loaned city money to co-workers, council members and businesses and urged police and code enforcement officers to increase city revenue by aggressively citing motorists, residents and business owners.

The controller's office found that the city had overcharged property owners and businesses more than $6 million in fees and had mysteriously placed $23.5 million in bond funds into a checking account that paid no interest, costing the city about $1.7 million in potential earnings.

In September, Chiang's office said Mayer Hoffman McCann should have noticed the glaring lack of internal controls in Bell. Chiang's report said Rizzo appeared to have complete control of all financial transactions and activity in the city.

Hallye Jordan, a spokeswoman for Chiang, said at the time that state auditors were baffled by "how a CPA firm could miss the abuses the controller's office found, and found rather quickly."

Bell was not the only city with auditing problems. A Times review of state and local records found that the independent audits cities are required to obtain frequently fail to uncover fraud and mismanagement.

Many cities hit with corruption or mismanagement allegations over the past decade, including San Diego, Compton and South Gate, received clean audits, even in cases where officials later were sent to prison.

When firms provide negative audits, they risk being replaced. In the case of Victorville, for instance, the new auditors gave the city a clean rating after the previous auditor found numerous problems.

-- Jeff Gottlieb

The New York Times

Room for Debate: A Running Commentary on the News

« Room for Debate Home

« Back to Discussion

What's Wrong With Accountants?

Ernst & Young may soon be sued for its role as auditor of Lehman Brothers. What kind of oversight do accounting firms need?

Getting at the Truth

Updated December 21, 2010, 10:28 AM

***Bethany McLean**, a contributing editor at Vanity Fair, is the co-author of "All the Devils Are Here: The Hidden History of the Financial Crisis."*

In the wake of Enron's collapse in the fall of 2001, Congress passed the Sarbanes-Oxley Act. Among other things, the federal law was intended to fix the problems in the accounting industry that helped enable Enron by separating the accounting profession from lucrative consulting businesses. This separation was meant to remove the conflict of interest that supposedly prevented the accountants from telling the truth.

Here we are today, and the news breaking that Andrew Cuomo might file suit against Ernst & Young for its role in helping Lehman Brothers mask the extent of its problems. Wait! Didn't we fix all that?

Today's financial industry may be too complex and too subject to opinions for the accountants to get right, even if they want to.

Well, no. The problems in the accounting industry run deeper than a mere separation between consulting and accounting.

Today's financial industry may be too complex and too subject to opinions for the accountants to get right, even if they want to. Witness PricewaterhouseCoopers, which audited both Goldman Sachs and AIG. At the height of the financial crisis, the exact same securities on each firms' books were valued at radically different prices. In other words, there was no way to compare the two firms' results.

The complexity makes the accountants even more susceptible to pressure from management. That pressure is all too real. And the problem in Enron's case was never the consulting business. It's that the accountants forgot who they were working for. They're supposed to work for investors, not management. Their job is to make sure investors have a fair chance at assessing a company's financial condition.

Until the accountants remember that, there will be more headlines. Which gets to the deepest underlying problem of all: There is no way to legislate an attitude change.

Topics: Andrew Cuomo, Business, Ernst & Young, Law, Lehman Brothers

Room for Debate: A Running Commentary on the News

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Updated December 21, 2010 05:26 PM

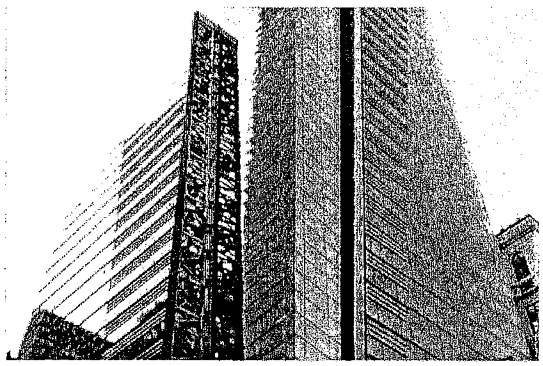
What's Wrong With Accountants?

Introduction

The New York attorney general, Andrew Cuomo, on Tuesday sued the accounting firm Ernst & Young, accusing it of helping Lehman Brothers "engage in a massive accounting fraud" by misleading investors about the health of the investment bank, which collapsed in 2008. The suit is the first major action by a regulator against an accounting firm in connection with a central player in the financial crisis.

Ernst & Young was severely criticized in a report issued in March by a court-appointed examiner, which concluded that it permitted Lehman to hide as much as $50 billion off its balance sheet to reduce its debt levels temporarily.

The Sarbanes-Oxley Act of 2002 was supposed to deal with the failure of accounting firms to scrutinize their clients' bookkeeping practices. Why hasn't that been sufficient? Are other kinds of oversight needed?



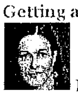
Lucas Jackson/Reuters

Ernst & Young's headquarters in New York on Monday.

Read the Discussion »

Debaters

Getting at the Truth



Bethany McLean, co-author, "All the Devils Are Here"

Window Dressing and Fraud

John C. Coffee, Jr., Columbia University Law School

Why Misconduct Is 'Normal'

Lynn Stout, U.C.L.A. Law School

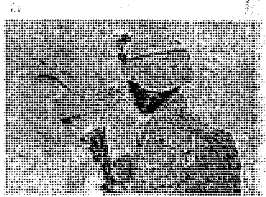
Problems With Accounting Standards

William Niskanen, Cato Institute

Recent Discussions

Are New York's Bike Lanes Working?

Why Remarry?



Obstacles to Leaving Afghanistan

CalCPA

1201 "K" Street, Ste. 1000
Sacramento, CA 95814
(916) 441-5351
www.calcpa.org

December 13, 2010

Attachment #3

Patti Bowers, Executive Officer
California Board of Accountancy
2000 Evergreen Street, Suite 250
Sacramento, CA 95815-3832

Dear Ms. Bowers:

Thank you for the opportunity to share insights developed during the long process to implement the 150 hour requirement as the only pathway to licensure in California. Developing national parity for California CPAs has been a major goal of the CPA profession in California for decades. The majority of California CPA candidates are currently choosing to be licensed under pathway 2 which requires completion of 150 hours of education. Legislation was introduced in 2009 to sunset the non-150 hour pathway to retain a "Substantially Equivalent" designation by the National Association of State Boards of Accountancy for California. Failure to retain this designation for California would have hampered California CPAs' ability to engage in interstate commerce on behalf of their clients and resulted in a loss of jobs with severe consequences for both California consumers and CPAs. With those issues in the background, CalCPA negotiated in good faith with the major opponent to previous legislation, the Center for Public Interest Law. CalCPA was not attempting to impose a fixed the number of ethics units required for licensing candidates, we were simply attempting to enact legislation that would meet the national minimum standard for entry to the CPA profession.

How did the Legislature come to specify the total number of units of ethics study at minimum of 10, as opposed to setting it at a lower or higher number?

Ten units was advanced by the Center for Public Interest Law as a condition to not oppose the legislation and agreed to by the California Society of Certified Public Accountants with the understanding and stipulation by all parties to the negotiation, that if the Committee found the number of units to be infeasible all the parties would weigh heavily the views of the Committee as to the number of units of ethics that were feasible.

What discussions occurred regarding the number of possible courses available to meet the requirement?

To our knowledge no discussions were held regarding the number of possible courses available to meet the requirement. What was discussed was the fact that ethics is embedded in much of the existing curriculum related to business, accounting, taxation and auditing subjects. Again, thank you for the opportunity to respond. Let us know if we can be of additional assistance.

Best regards,

BRUCE C. ALLEN, Director
Government Relations

State of California
Department of Consumer Affairs

Attachment 6

California Board of Accountancy
2000 Evergreen Street, Suite 250
Sacramento, CA 95815-3832

Memorandum

ECC Agenda Item VII.
January 26, 2011

To : ECC Members

Date : December 15, 2010

Telephone : (916) 561-4367
Facsimile : (916) 263-3672
E-mail : cfuller@cba.ca.gov

From : Cindi Fuller, Coordinator
Licensing Division

Subject : Future Meeting Dates

For your consideration and approval, please find the following proposed ECC meeting dates for 2011. In keeping with the request of ECC members to hold future meetings on the same day of the week, it is suggested ECC meetings be held on the Wednesday before California Board of Accountancy (CBA) meetings. The proposed calendar has the ECC meeting every other month. Members will need to consider if they wish to meet this often or possibly on a quarterly basis (still in conjunction with CBA meetings). The 2011 CBA Year-at-a-Glance calendar is attached for your reference.

March 23, 2011 – San Diego
May 18, 2011 – San Jose
July 20, 2011 – Los Angeles
September 21, 2011 – Sacramento
November 16, 2011 – San Francisco

I will be available to answer any questions or concerns regarding these proposed meeting dates.

Attachment

CALIFORNIA BOARD OF ACCOUNTANCY (CBA)
PROPOSED 2011 MEETING DATES/LOCATIONS
(CBA MEMBER COPY)

JANUARY 2011

S	M	T	W	Th	F	S
						1
2	3	4	5	6	7	8
9	10	11	12	13	14	15
16	17	18	19	20 NC	21	22
23 / 30	24 / 31	25	26 SC	27 SC	28 SC	29

FEBRUARY 2011

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27	28					

MARCH 2011

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27	28	29	30	31		

APRIL 2011

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MAY 2011

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29	30	31				

JUNE 2011

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JULY 2011

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24 / 31	25	26	27	28	29	30

AUGUST 2011

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SEPTEMBER 2011

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25	26	27	28	29	30	

OCTOBER 2011

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23 / 30	24 / 31	25	26 SC	27	28	29

NOVEMBER 2011

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13	14	15	16	17 NC	18 NC	19
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27	28	29	30			

DECEMBER 2011

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				1	2	3
4	5	6	7	8	9	10
11	12	13	14	15	16	17
18	19	20	21	22	23	24
25	26	27	28	29	30	31

COMMITTEE/TASK FORCE

EAC-ENFORCEMENT ADVISORY COMMITTEE
QC-QUALIFICATIONS COMMITTEE
AEC - ACCOUNTING EDUCATION COMMITTEE
ECC - ETHIC CURRICULUM COMMITTEE
PROC - PEER REVIEW OVERSIGHT COMMITTEE

GENERAL LOCATION

NC-NORTHERN CALIFORNIA
SC-SOUTHERN CALIFORNIA

- ON SHADED DATES CBA OFFICE IS CLOSED
- CBA MEETING
- DCA CONFERENCE
- CBA WORKING CONFERENCE
- SPECIAL CBA MEETING ON LEGISLATION
- EAC MEETING
- QC MEETING
- AEC MEETING
- ECC MEETING
- PROC MEETING

12/1/2010